Supreme Court, U. S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-1718

UNION PACIFIC RAILROAD COMPANY,

Petitioner,

—v.—

THE UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

APPENDIX B

Opinion of Court of Claims

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In the United States Court of Claims

No. 310–62

(Decided October 22, 1975)

UNION PACIFIC RAILROAD CO., INC. v.
THE UNITED STATES

Robert J. Casey, attorney of record, for plaintiff. *Frank E. Barnett, Covington Hardee, Thomas J. McCoy, Jr., John A. Craig, James E. Pratt, David J. Sweet, Clark, Carr & Ellis*, of counsel.

Theodore D. Peyser, Jr., with whom was *Assistant Attorney General Scott P. Crampton*, for defendant.

Before COWEN, *Chief Judge*, LARAMORE, *Senior Judge*, SKELTON, NICHOLS, KASHIWA, KUNZIG, and BENNETT, *Judges*.

OPINION

KUNZIG, *Judge*, delivered the opinion of the court:

This income tax refund case comes before the court on appeal from the Trial Division where findings and an opinion were filed November 9, 1973, by Trial Judge David Schwartz, pursuant to Rule 134(h). The court has reviewed his decision on the briefs, exceptions, and oral argument of counsel, finds itself in agreement with major portions of that recommended decision and adopts them, with minor modification, as Parts I–II and IV–X of its opinion. The court also adopts most of the trial judge's findings of fact, but modifies portions deemed proper upon consideration of exceptions by the parties. We limit our departure essentially to Parts III and XI of this opinion.

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In Part I we deal with plaintiff's claim that it had a right to "expense" certain property costing less than $500 ("minimum rule" property) in its 1942 tax return. In Part II we consider the 1942 deductibility of plaintiff's payroll taxes paid in 1943. In Part III we treat the issue of whether plaintiff may return $13 million to income based upon 1900–1907 accounting errors. In Part IV we handle plaintiff's assertion that certain stock subscription rights received could be included in income. In Part V we resolve plaintiff's request to include stock in certain leased line subsidiaries in its capital assets. In Part VI we answer plaintiff's demand for interest on a 1948 agreement with the Internal Revenue Service. In Part VII we respond to plaintiff's plea to include certain land sale proceeds in its earnings and profits. In Part VIII we decide defendant's "additional defense" that plaintiff erroneously included bond discounts and expenses in its total assets. In Part IX we rule on another additional defense that plaintiff failed to treat other bond discounts, and call premiums as interest. In Part X we pass on plaintiff's entitlement to include certain donations and grants in its equity. Finally, in Part XI we determine the correct amount of plaintiff's equity invested capital based on the value of its stock issued for its operating assets.

We find that plaintiff is entitled to recover in Parts I, V and in some sections of Part X. Plaintiff does not prevail in Parts II, IV, VI and VII. We hold for defendant on its offset claims in Parts VIII, IX and XI. Finally, we remand the issue in Part III for reconsideration by the trial judge.

The Union Pacific Railroad Company brings suit pursuant to the Tucker Act (28 U.S.C. § 1491) and the Internal Revenue Code (§ 7422(a), 1954 Code) for a refund of income and excess profits taxes for 1942. Plaintiff has paid over $30 million in income tax and over $7 million in excess profits tax. It seeks a judgment for $13,409,961.46 (consisting of $9,222,801.78 in statutory interest for 1942 and $4,187,159.68 in income and excess profits tax and assessed interest thereon paid for 1942) or such other amount which may be legally refundable for 1942, together with statutory interest thereon.

The extraordinary span of time from 1942 to the filing of suit is accounted for by the following. The taxpayer filed

returns in 1943 and made payments of a total of some $42 million in 1943, 1944 and 1946. Between that time and the conclusion of the audit of the returns in 1957, various timely claims for refunds were filed in amounts varying from $7.7 million to $348,000, and various credits, adjustments and refunds were made in amounts ranging from $694,000 to $196.

The audit, begun in 1945, was completed in 1957. One Internal Revenue agent spent over 5,000 hours, or about 630 working days, on the report, almost 1,000 pages long. The major part of the work was the required preparation of the surplus or accumulated earnings and profits accounts for 25 closely related or subsidiary corporations for the 44 years from 1898, the year of the creation of the taxpayer on the reorganization of the old Union Pacific Railroad. These accounts were directly relevant to the invested capital method chosen by plaintiff for reporting its tax under the World War II excess profits tax act (Title II, § 201, Second Revenue Act of 1940, 54 Stat. 975, 26 U.S.C. §§ 710–752 (1940 ed.)). The primary issue is the valuation of the original Union Pacific Railroad system. This and other major issues required the study of voluminous documents and underlying data located at various points in the country. Various other factors contributing to the length of the audit period included the pendency until 1954 of suits, brought by the taxpayer for earlier tax years, affecting some of the issues involved in 1942 tax liability.

The returns were meantime kept open by consents on the part of the taxpayer. Plaintiff did not press for an early submission of the agent's report, for reasons connected with a certain agreement with the Commissioner concerning freight "cutbacks" or rate refunds, discussed below. It is agreed that the consents were voluntary and without any pressure or coercion and that at no time did plaintiff complain to the Internal Revenue Service concerning the time required to complete the audit of its returns.

The audit, completed in 1957, was the basis of a determination in 1959 of a large net overassessment of tax for 1942. On September 16, 1960, after approval of the determination by the Joint Congressional Committee on Internal Revenue Taxation, a deficiency in excess profits tax for 1942 was satis-

fied by credits in income tax and a post-war credit, and a total of $7,793,219.55 was refunded or paid to plaintiff, consisting of income tax and declared value excess profits tax for 1942 and statutory interest thereon.

In 1961 plaintiff filed a timely comprehensive claim for refund of $13,409,961.46, together with interest, and on notice of disallowance, the instant suit was timely brought, on September 14, 1962. The petition as first filed contained 27 counts, to which seven counts were added by an amended petition in 1966. In an answer and four amended answers filed in 1966 and 1968 the Government pleaded 22 separate additional defenses.

Aspects of the case have finally been disposed of as follows. On January 19, 1968, the court pursuant to the Government's additional defense 11 dismissed counts 27 through 30 and 32 through 34 as claims for refund, allowing them to remain only as offsets to defendant's setoffs. 182 Ct. Cl. 103, 389 F. 2d 437 (1968), *cert. denied*, 403 U.S. 931 (1971). Summary judgment dismissing counts 29 and 30 was granted in 1968, thus rendering additional defenses 14 and 15 moot. 185 Ct. Cl. 393, 401 F. 2d 778 (1968), *cert. denied*, 395 U.S. 944 (1969), *motion for reconsideration denied*, 194 Ct. Cl. 1021. Counts 7 and 31 and the additional defenses thereto, Nos. 2, 3, 4 and 10, were ordered separately tried, after final adjudication of the remaining issues, by then Trial Commissioner (now Judge of the U.S. Customs Court) Herbert N. Maletz.

The parties have through their able and diligent counsel engaged in extensive and fruitful pretrial proceedings and negotiations. A substantial number of counts and affirmative defenses were in the course of these proceedings conceded by one or the other party, by agreements limited to this proceeding.

Whole counts and additional defenses which have been conceded, by agreements limited to this proceeding, are these: it is conceded that plaintiff is entitled to prevail on counts 1 and 16; it is conceded that plaintiff is not entitled to prevail on counts 3, 10 through 14, and 27 (thus rendering additional defense 5 moot); and it is conceded that the defendant is not entitled to prevail on additional defenses 12 and 13. Count 28 is entirely disposed of by agreement. A

number of partial concessions of counts were also made as to counts 17, 20, 21 and 22 and additional defense 20. Various items in counts 19–25 not agreed upon by the parties are disposed of in other counts.

The pretrial proceedings culminated in a stipulation of facts of approximately 500 pages, over 500 exhibits agreed by the parties to be received in evidence or ruled upon in advance of trial and an exchange before trial of the direct testimony of the experts to be called by the parties on the valuation issue. The case was tried between February 26 and March 6, 1969. Testimony consisted of the cross and redirect examination of the expert witnesses, and testimony by three additional witnesses. Proposed findings of fact, objections to proposed findings of fact and briefs were filed between October 13, 1969 and January 5, 1971, and further memoranda were filed in May and June, 1973.

I. "MINIMUM RULE" ACQUISITIONS

The Interstate Commerce Commission's rules for accounting by railroads, effective in 1940–1942, required that items of road and equipment property costing less than $500 be charged to operating expenses rather than to a capital account. Such a rule, known as the "minimum rule," had been in effect for many years; in 1940 the break point was raised from $100 to $500. The Government challenges the effectiveness for tax purposes of the change in the rule. The contention is that (1) items of property costing between $100 and $500, concededly of a capital nature and having a useful life of longer than a year, are "permanent improvements" under section 24(a)(2) of the 1939 Code, must be capitalized, and only depreciation deducted, and (2) the minimum rule does not constitute a method of accounting under section 41 of the Code. Plaintiff deducted $113,717.84 for such items, and it is this deduction which is in dispute in count 2.

A similar case has been considered by the court and decided in favor of the taxpayer in *Cincinnati, N.O. & Tex. Pac. Ry.* v. *United States*, 191 Ct. Cl. 572, 424 F. 2d 563 (1970). The minimum rule items, the court held, "are not of such nature or character in relation to the plaintiff's business to constitute permanent improvements or betterments as is con-

templated by section 24(a)(2)"; further, that the minimum rule treatment of the items was "in accordance with generally accepted accounting principles and is not such that it inhibits the ability of plaintiff's financial statements to clearly reflect income for tax purposes"; and, finally, that "the minimum rule constitutes a method of accounting as contemplated by section 41 and Treas. Reg. 111, § 29.41–3." 191 Ct. Cl. at 587–88, 424 F. 2d at 572–73.

Defendant seeks to distinguish the decision on the ground that the tax consequences there were *de minimis* while here they are substantial. Substantiality is attempted to be shown by pointing to such facts as the excess of the deductions taken by plaintiff pursuant to the minimum rule over the depreciation allowed by the Commissioner, amounting to $109,926 in 1942, $147,017 in 1943, $175,682 in 1944, $171,850 in 1945 and $115,551 in 1946. The total of $720,026 for the 5 years is said to be substantial.

Dollar figures, even large ones, are not a showing of substantial tax consequences in a case of this type. Whether an accounting method distorts the reflection of income must depend on a whole picture. As the court said in *Cincinnati, N.O. & Tex. Pac. Ry.* v. *United States*, *supra*, "[t]he most convincing evidence that the Commissioner has abused his discretion in prohibiting the plaintiff from treating items [in accordance with the minimum rule] . . . is the statistical analysis . . . which indicates the relationship of the quantum of minimum rule expenses to other substantial income and balance sheet figures." 191 Ct. Cl. at 584, 424 F. 2d at 571.

Let us therefore compare the relationships in the instant case with those held by the court not to inhibit the ability of the Cincinnati's financial statements to reflect its income clearly. In 1942 the Cincinnati's total operating expense was $16,291,053; total investment account was $69,391,628; and challenged minimum rule items were $9,688. For plaintiff the comparable figures were $218,307,770, $442,726,752 and $113,718. The ratio of minimum rule items to total investment account for the Cincinnati was thus .00014; for plaintiff it is .00026. The ratio of minimum rule items to total operating expense for the Cincinnati was .00059; for plaintiff it is .00052.

The relationships are, therefore, as minimal in plaintiff's fiscal picture as they were in Cincinnati's. There is accordingly no reason not to follow the court's recent decision and affirm the right of the plaintiff to account for the items in question in 1940–1942, pursuant to the ICC's minimum rule.

Plaintiff is entitled to prevail on count 2.[1]

II. PAYROLL TAXES

The dispute, raised by count 4, is over whether the plaintiff, having been permitted by the Commissioner of Internal Revenue to deduct from its 1942 income, as a business expense, the amount of vacation pay earned by plaintiff's employees in that year and paid to them in 1943, should also be permitted to deduct the payroll taxes applicable to the vacation pay, which were payable and paid in 1943. Plaintiff is on the accrual and calendar year basis. The payroll taxes were those imposed by section 1520 of the Internal Revenue Code of 1939, 26 U.S.C. § 1520 (1940)[2] and Section 8(a) of the Railroad Unemployment Insurance Act, ch. 680, 52 Stat. 1094, 1102 (1938), 45 U.S.C. § 358 (1940).[3]

Plaintiff's contentions were apparently not reflected in its tax returns as first filed. In its return for 1942, plaintiff deducted, as business expenses, $1,103,413.31 in vacation pay

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[1] Since plaintiff prevails on count 2, we do not decide plaintiff's alternative claims based on the minimum rule treatment in counts 32 and 33, nor need we consider defendant's contentions in additional defenses 16 and 17 based upon counts 32 and 33.

[2] "§ 1520. *Rate of Tax.*

"In addition to other taxes, every employer shall pay an excise tax, with respect to having individuals in his employ, equal to the following percentages of so much of the compensation as is not in excess of $300 for any calendar month paid by him to any employee for services rendered to him after December 31, 1936 • • •

• • • • •

"(2) With respect to compensation paid to employees for services rendered during the calendar years 1940, 1941, and 1942, the rate shall be 3 per centum;

"(3) With respect to compensation paid to employees for services rendered during the calendar year[s] 1943, 1944, and 1945, the rate shall be 3¼ per centum;

"• • • • •"

[3] "Sec. 8. (a) Every employer shall pay a contribution, with respect to having employees in his service, equal to 3 per centum of so much of the compensation as is not in excess of $300 for any calendar month payable by him to any employee with respect to employment after June 30, 1939: • • •."

earned by its employees in 1941 and paid to them in 1942, and payroll taxes on the vacation pay, in the amount of $64,108.31, paid in 1942. Consistently, on its return for 1943 plaintiff deducted $1,518,624.02 in vacation pay earned by employees in 1942 and paid to them in 1943, and the applicable payroll taxes of $90,358.13, paid in 1943.

During the audit of its 1942 return, the plaintiff claimed, and the Commissioner allowed, a deduction of the entire amount of the vacation pay earned by its employees in 1942, $1,518,624.02. Relying on the allowance, the plaintiff then made a claim for refund on the ground that it was entitled in 1942 to accrue and deduct the payroll taxes on the entire amount of vacation pay whose deduction had been allowed. The claim was actually one for $26,249.82, the difference between $90,358.13, the amount of the payroll tax claimed as a deduction, and the deduction of $64,108.31 taken on the return. The Commissioner denied the claim and count 4 of the petition seeks the $26,249.82 involved.

The question for decision is whether plaintiff may in 1942 accrue and deduct payroll taxes to be paid in 1943 on vacation pay which was earned, accrued and allowed to be deducted in 1942, though not to be paid until 1943. The answer here given is, no. The reasons follow.

A tax not assessed and paid until a following year may nevertheless be deducted in the prior year, if it meets the "all events" test of *United States* v. *Anderson*, 269 U.S. 422 (1926). By that test a deduction may be taken, in advance of assessment, in the year when all the events take place determining liability and fixing the amount of the tax. Thus (*id.* at 441):

> In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it. In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions tax here in question did not stand on any different footing than other accrued expenses appearing on appellee's books.

The "all events" test has been restated and applied many times, often in cases similar to the instant case. *E.g.*, *United*

States v. *Consolidated Edison Co.*, 366 U.S. 380, 385, n.5 (1961); *Clevite Corp.* v. *United States*, 181 Ct. Cl. 652, 658, 386 F. 2d 841, 843 (1967); *Denver & Rio Grande Western Railroad Co.* v. *Commissioner*, 38 T.C. 557, 572 (1962); *Turtle Wax, Inc.* v. *Commissioner*, 43 T.C. 460, 466–67 (1965). The test is phrased in the current income tax regulations as follows: "Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy." Treas. Reg. § 1.461–1(a)(2) (1970), promulgated by T.D. 6282, 1958–1 Cum. Bull. 215, 22 F.R. 10686, Dec. 25, 1957, 26 C.F.R. § 1.461–1(a)(2)(1970).

So long as a liability remains contingent or if the liability has attached but the amount cannot be reasonably estimated, a business expense deduction is not allowed. Treas. Reg. § 1.461–1(a)(2), *supra; Clevite Corp.* v. *United States*, *supra; Texaco-Cities Service Pipe Line Co.* v. *United States*, 170 F. Supp. 644, 645 (1959); *Denver & Rio Grande Western Railroad Co.* v. *Commissioner*, *supra; Turtle Wax, Inc.* v. *Commissioner*, *supra.*

In the instant case, both the fact of liability and the amount of tax were as of December 31, 1942 still in doubt. Uncertainty as to two events as of that date made it impossible then to determine the tax.

One of the facts lacking was knowledge of the total vacation pay which plaintiff's employees would actually receive. Under at least some of plaintiff's labor contracts, the employee forfeited the right to a vacation with pay or to pay in lieu of a vacation, if his employment were terminated, for a reason other than retirement, prior to the time scheduled for his vacation in 1943. Since it could not be known by the end of December of the prior year, 1942, which of plaintiff's employees would remain in its employ until the beginning of their respective vacations in 1943, it could not in 1942 be determined how much vacation pay plaintiff would be required to pay and, therefore, what would be plaintiff's tax liability. The uncertainty would not be resolved until the time in 1943 of the actual payment of vacation wages or allowances. All events fixing liability not yet having occurred, a deduction in advance, in 1942, is not permitted,

under the foregoing authorities, and particularly *Texaco-Cities Service Pipe Line Co.* v. *United States*, *supra*, and *Turtle Wax, Inc.* v. *Commissioner*, *supra*. Compare similar rulings with respect to the excise tax on payrolls of employers other than carriers. G.C.M. 19692, 1938–1 Cum. Bull. 148; Rev. Rul. 69–587, 1969–2 Cum. Bull. 108.

Plaintiff urges that in allowing it to deduct vacation pay earned in 1942, the Commissioner has ruled, pursuant to I.T. 3956, 1949–1 Cum. Bull. 78, that the liability for vacation pay is not made contingent for purposes of the "all events" test by the possibility that the employee might forfeit his right to a vacation by leaving the employ prior to his scheduled vacation. The Government's position on I.T. 3956 is that the ruling was mistaken and has been revoked in Rev. Rul 54–608, 1954–2 Cum. Bull. 8, 9–10; moreover, that it concerned vacation pay and should not be extended to payroll taxes.

In revoking I.T. 3956 the Commissioner ruled "that no accrual of vacation pay can take place until the fact of liability to a specific person has been clearly established and the amount of the liability to each individual is capable of computation with reasonable accuracy." Rev. Rul. 54–608, *supra*. In reaching this decision, the Commissioner relied on three decisions of the Tax Court: *Tennessee Consolidated Coal Co.* v. *Commissioner*, 15 T.C. 424 (1950); *Morrisdale Coal Mining Co* v. *Commissioner*, 19 T.C. 208 (1952); and *E. H. Sheldon & Co.* v. *Commissioner*, 19 T.C. 481 (1952). In these cases it had been held that liability for payment of vacation pay depended on the condition precedent that the recipient employee be working for the employer-taxpayer on the date required by the contract, and that until that date liability remained uncertain.

The reasoning of Rev. Rul. 54–608 and of the cases it relied upon is preferred over that of I.T. 3956. This court has recently ruled that where "payment of vacation pay * * * is contingent upon employment up to the beginning of the vacation period, a taxpayer cannot accrue expenses for vacation pay before the taxable year in which the payments are made. Until the vacation period begins, the 'all events' test * * * has not been satisfied." *Clevite Corp.* v. *United States*, *supra*.

Plaintiff urges that the effective date of Rev. Rul. 54–608 has been repeatedly postponed (most recently in Section 903 of the Tax Reform Act of 1969, P.L. 91–172, 83 Stat. 487, 711), and thus that I.T. 3956 is "still the law." The question at hand, however, is not the present effectiveness of I.T. 3956, as governing deductibility of vacation pay by certain classes of taxpayers,[4] but whether its rationale should be extended to the deductibility of payroll taxes on vacation pay. That question is here answered in the negative.

The nature of the payroll tax itself is the source of the second "event" or fact so unknown or uncertain at the close of 1942 as to make the liability contingent and thereby prevent deduction of payroll taxes in that year. The two payroll tax acts (notes 2 and 3, *supra*) subjected to tax only the first $300 of compensation paid to an employee in any calendar month. Under plaintiff's labor contracts, in the event plaintiff could not release an employee for a vacation in 1943, it was obligated to pay the employee an allowance in lieu of the vacation. Where such an allowance was paid in a calendar month in which the employee had already received $300 or more in other compensation, no tax would be due on the excess of $300.

Plaintiff did not know, as of December 31, 1942, which of its employees it would and which it would not be able to release for a vacation in 1943, and to which, therefore, it would pay allowances in lieu of vacation. Unknown, therefore, was how many would receive more than $300, in combined regular pay and vacation allowance, in one calendar month, and thus to what extent the payment of vacation allowances would be free of tax. Liability for the tax was necessarily contingent, until the time of the scheduled vacation in 1943. Only then would it appear how much of the payments to the employee would be liable to tax.

The effect of the $300 maximum on a taxable monthly compensation is confirmed by the facts of plaintiff's actual pay-

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[4] The postponement of the revocation was intended for those who, in reliance on I.T. 3956, were accruing and deducting vacation pay in the year in which it was earned, and who, in the first year of an effective revocation of I.T. 3956, would be left with no deduction. The postponement is designed to allow time for study and formulation of remedial legislation. *Denver & Rio Grande Western Railroad Co.* v. *Commissioner*, *supra*; S. Rep. No. 91–552, 91st Cong., 1st Sess. 275–77 (1969).

ments of vacation pay and tax. Plaintiff paid $1,103,413 in vacation pay in 1942. Six percent of this amount—the tax rate in 1942 (notes 2 and 2, *supra*)—is $66,205, yet plaintiff paid payroll taxes of only $64,108. In 1943 plaintiff paid vacation pay of $1,518,624. At 6.25 percent, the tax rate in 1943 (notes 2 and 3, *supra*), it would have paid $94,914, yet plaintiff paid only $90,358. The differences between the amount of the tax payable, if the entire amount of vacation pay were taxable, and the amount of tax actually paid, not explained by plaintiff, can only be attributed to payments of regular pay and vacation allowances in total amounts of over $300 in a month, of which the portion over $300 was free of tax.

Plaintiff contends that the effect of the tax freedom for compensation over $300 in one month is not so great as to disqualify the tax from deductibility because, it is said, plaintiff was able, in 1942, to estimate the amount of tax to be paid with the accuracy required by the "all events" test. Not so. While the amount of a tax may be reasonably estimated and need not be precisely known, liability for the tax must have attached and cannot be approximated or estimated. "[T]he fact that the percentage of items which will be paid can be estimated with reasonable accuracy is not sufficient to support accruals. The individual items must represent fixed liabilities." *Denver & Rio Grande Western Railroad Co.* v. *Commissioner*, *supra*. The accruability test is not whether there is certainty of payment, or if a reasonable estimate can be made, but whether there is certainty of liability. *Trans-California Oil Co., Ltd.*, 37 B.T.A. 119, 127 (1938). Here, liability was not certain or fixed. The effect of the $300 provision was to make the liability for tax uncertain, until the time when the employee actually went on vacation or received both pay and vacation pay. Liability for payroll tax was thus under the "all events" test not certain or fixed in 1942. *Texaco-Cities Service Pipe Line Co.* v. *United States*, *supra; Helvering* v. *Russian Finance & Construction Corporation*, 77 F. 2d 324, 327 (2d Cir. 1935).

Lastly, plaintiff urges that since it has been allowed a deduction for vacation pay earned in 1942, a comparable deduction for the tax on such vacation pay is appropriate or necessary in order clearly to reflect its income for 1942. The

effect on income in any year of the prospective payroll tax may be clearly enough reflected by a reserve for the tax as a contingent liability. The need for such a reserve is not the equivalent of a right to a deduction. *Lucas* v. *American Code Co.*, 280 U.S. 445, 452 (1930).

Plaintiff is not entitled to prevail on count 4.

III. $13 MILLION DEDUCTIONS

Plaintiff's count 8 also seeks a refund of excess profits taxes based upon an alleged series of accounting errors in 1900–1907. It asserts that certain "betterments and improvements" during these years were "expensed" rather than debited to its investment account. It further contends that in later years, these "betterments" were depreciated and thus "expensed" for a second time. Plaintiff wants to "reverse" this $13 million accounting error by adding it back into accumulated earnings and profits.

The trial judge rejected this claim. He found insufficient proof that the accounting transactions were erroneous, and noted that plaintiff had failed to succeed on this same argument in a case before the Interstate Commerce Commission. 44 ICC Val. Rep. 1, 22 (1933).

The trial judge discredited plaintiff's contention that later depreciation deductions created a "double expensing" of a single item of property. He found that the evidence shows that plaintiff in fact made "*substantial unrecorded retirements*" rather than later retirement deductions. It is this point which troubles the court. The "unrecorded retirement" issues are still before the trial judge. Plaintiff contends that if the court denies its "$13 million" claim for the sole reason that these accounting entries were made to *correct* earlier "retirement errors," and if it is later found that its "retirement" practices were correct, plaintiff will have lost the right to alter the "$13 million" entries.

Since the retirement issue is still before the trial judge, the court remands this "$13 million" issue to the trial judge for clarification of the relationship between the retirement issue and the "$13 million" issue. Although it appears that the trial judge rejected plaintiff's claims solely for insufficient proof of a "$13 million" error, we wish to make absolutely certain that his conclusion is not tied to any findings of "erroneous

retirement" practices by plaintiff, or that plaintiff was not lured into failure to present proof on the "$13 million" issue because it believed the issue would be tried with the retirement issues.

IV. STOCK SUBSCRIPTION RIGHTS

In each of the years 1922, 1923, and 1925 plaintiff and its wholly owned subsidiary, the Oregon Short Line, both holders of common stock in the Illinois Central Railroad Company, received, as such holders, a distribution of rights to subscribe to Illinois Central convertible preferred stock at $100 per share. The rights were exercised in the year received. At both the time of distribution and exercise, the market value of the stock was higher than the subscription price. The lower of the two aggregate "spreads" between market and distribution prices was some $670,000.

The question presented, determinative in count 15, and determinative in part in other counts, is whether the "spread" at either time was income properly to be included in accumulated earnings and profits of the recipient for excess-profits-tax purposes. The answer, here given in the negative, hinges on the checkered history of the taxation of stock dividends prior to the enactment of the excess profits tax in 1940.

That history begins with the 1918 decision holding the 1913 tax on income inapplicable to a dividend in stock, on the ground that the "proportional interest of each shareholder remains the same" after the receipt of the dividend. *Towne* v. *Eisner*, 245 U.S. 418, 426. In 1916, however, Congress had by statute directed that a "stock dividend shall be considered income, to the amount of its cash value." Section 2(a)(2), Revenue Act of 1916, ch. 463, 39 Stat. 757 (1916). This statute the Supreme Court soon held in violation of the Sixteenth Amendment, in *Eisner* v. *Macomber*, 252 U.S. 189 (1920), on the ground that no income had been received. Though the two cases had involved simple dividends of common stock to common stockholders, Congress took the decisions as forbidding the taxation as income of any stock dividends, and accordingly provided in the 1921 Act and thereafter, through the 1934 Act, that a "stock dividend shall not be subject to tax." [5]

[5] Section 201(d), Revenue Act of 1921, ch. 136, 42 Stat. 228 (1921); § 201(f), Revenue Act of 1924, ch. 234, 43 Stat. 255 (1924); § 201(f), Revenue Act of 1926, ch. 27, 44 Stat. 11 (1926); § 115(f), Revenue Act of 1928, ch. 852, 45 Stat. 822 (1928); § 115(f), Revenue Act of 1932, ch. 209, 47 Stat. 204 (1932); § 115(f), Revenue Act of 1934, ch. 277, 48 Stat. 712 (1934).

The premise of this statutory exemption of stock dividends from taxation was upset in 1936 when the Supreme Court decided in *Koshland* v. *Helvering*, 298 U.S. 441, that a dividend in common stock to holders of preferred stock gave rise to income (though not subjected to tax), because the resulting interest of the stockholder was different than before. Now appreciating that *Eisner* v. *Macomber* was not an absolute, and that some stock dividends could be taxable, Congress promptly provided, in the 1936 Act, that dividends in stock or in rights should be taxable to the extent constitutionally permissible.[6] Such taxation as was thereby imposed was to be prospective.[7] These provisions were repeated in the 1939 Code.[8] Under these provisions, such stock dividends as gave rise to income, that is, those that created interests in the recipient different than before, were taxed. See *Helvering* v. *Griffiths*, 318 U.S. 371 (1943); Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders*, Sec. 5.60 (2d ed.).

Such briefly had been the prior treatment of stock dividends when the excess profits tax was being considered in 1940. Though the change in the taxation of stock dividends in 1936 did not rake up stock dividends of earlier years, the excess profits tax would do so, by its provision that accumulated earnings and profits be an element of equity invested capital. 50 U.S.C. § 718 (1940 ed.). Computation of equity invested capital would require a review and determination of the earnings and profits account of at least some corporate taxpayers from the beginning (one of the causes of the long time spent in auditing the return of the instant plaintiff). On such a review, in the absence of special statutory provision, at least some long-past stock dividends would now by hindsight be understood as having given rise to income and thus includible in earnings and profits, though the dividend had been exempt from tax under the statutes in force between 1921 and 1936.

[6] Section 115(f)(1), Revenue Act of 1936, ch. 690, 49 Stat. 1688 (1936):
"A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution."

[7] Section 1, Revenue Act of 1936, ch. 690, 49 Stat. 1652 (1936).

[8] Section 115(f)(1), 1939 Code, 26 U.S.C. § 115(f)(1) (1940 ed.).

Special statutory provision was, however, made. Congress dealt explicitly with the effect upon earnings and profits of past, untaxed stock dividends. The draftsmen added to the excess profits tax law a provision that earnings and profits should not be increased by receipt of a dividend, not taxed, whose only effect had been to cause a reallocation of the basis of the old stock to the old and the new stock. This section, quoted in the note,[9] was section 115(1), 1939 Code, 26 U.S.C. § 115(a)(1) (1940 ed.), added by § 501, Second Revenue Act of 1940, ch. 757, 54 Stat. 1004 (1940). Retroactivity was explicit. Section 501(c), Second Revenue Act of 1940, ch. 757, 54 Stat. 1005.[10]

The precise question for present decision is simply whether the distributions of rights to plaintiff and Oregon Short Line were tax-free dividends subject to the bar of § 115(1) to their inclusion in the earnings and profits of the recipient corporation.

The issues are those of construction of § 115(1) and related sections. A first issue is whether the distribution of rights to subscribe to the preferred stock of Illinois Central, the distributing corporation, was a "dividend." It is agreed, incidentally, that Illinois Central had sufficient income available for dividends in the amounts involved.

Distribution of rights to subscribe to stock in the issuer, such as are presently involved, are for tax purposes the equivalent of stock dividends. It is settled that a distribution of rights to subscribe to stock is governed by the same rules as determine taxability of the stock itself, had it been directly distributed. *Miles* v. *Safe Deposit Co.*, 259 U.S. 247 (1922);

[9] "Where a corporation receives (after February 28, 1913) a distribution from a second corporation which (under the law applicable to the year in which the distribution was made) was not a taxable dividend to the shareholders of the second corporation, the amount of such distribution shall not increase the earnings and profits of the first corporation in the following cases:

"(1) No such increase shall be made in respect of the part of such distribution which (under such law) is directly applied in reduction of the basis of the stock in respect of which the distribution was made.

"(2) No such increase shall be made if (under such law) the distribution causes the basis of the stock in respect of which the distribution was made to be allocated between such stock and the property received."

[10] "For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section [§ 501(a), adding § 115(a)(1)] shall be effective as if they were a part of each such Revenue Act on the date of its enactment. * * *"

Choate v. *Commissioner*, 129 F. 2d 684 (2d Cir., 1942); *Charles M. Cooke, Ltd.* v. *Commissioner*, 2 T.C. 147 (1943). Thus a distribution of rights to subscribe is not subject to tax as a dividend, when the stock itself, had it been distributed directly, would not be subject to tax, whether because of the nature of the stock dividend or because of a statutory exemption from tax. *Miles* v. *Safe Deposit Co.*, *supra*; *Charles M. Cooke, Ltd.* v. *Commissioner*, *supra*.[11] And a distribution of rights is taxable when distribution of the stock would be taxable, as it was under the 1936 Act, which taxed stock dividends to the extent constitutionally permissible. *Choate* v. *Commissioner*, *supra*.

Why, then, was the distribution of rights not a dividend? Plaintiff claims that the transactions in which the rights were distributed were not distributions of dividends but offers to sell corporate property to the corporation's stockholders at less than its value, which on acceptance by the exercise of the rights gave rise to income in the amount of the lesser of the spreads between market and subscription price at the times of distribution and exercise.

Palmer v. *Commissioner*, 302 U.S. 63 (1937) and *Commissioner* v. *Gordon*, 391 U.S. 83 (1968), cited by plaintiff, do support the proposition for which they are invoked—that the sale of corporate property to stockholders at less than its value is as much a distribution of profits subject to tax as income as the formal declaration of a dividend in money. In these cases the property distributed to stockholders was stock in a corporation other than the distributing corporation. Such stock is when distributed as a dividend no differently treated than is other property. Dividends consisting of stock in the issuing corporation are, however, another matter, subject, as has been seen, to special statutory treatment. The rule governing dividends by offer to sell property is therefore not relevant to the problem at hand. The aspect of that rule, much emphasized by plaintiff, fixing the realization of income at the time of acceptance of the offer as against

[11] Consistently, Article 39 of Treasury Regulations 62, issued under the Revenue Act of 1921, as amended by T.D. 3403, I–2 Cum. Bull. 64 (1922), provided that "Where a corporation issues to its stockholders the right to subscribe to its stock, the value of the right does not constitute taxable income to the stockholder * * *."

the time of distribution of the right to buy is as irrelevant as the rule itself.

Accordingly, the criticisms of treatment of the instant distribution as a dividend are invalid. The distributions are dividends within the meaning of § 115(1), if the section is otherwise applicable. The remaining questions have to do with the two conditions for its application stated in § 115(1) (note 8, *supra*).

The first of these is whether the distributions involved were free from tax, for § 115(1) by its terms governs only a distribution "which (under the law applicable to the year in which the distribution was made) was not a taxable dividend." Note 9, *supra*.

The distributions, made in 1922, 1923 and 1925, were in fact not taxed. In the years in question, petitioner and Oregon Short Line, in their consolidated returns, did not include in gross income any amounts as attributable to the receipt of the rights in question. The omission cannot, however, be regarded as a conclusive recognition by the taxpayer that the distributions were not taxable income, for in those years 100 percent of dividends received from domestic corporations were deductible. Section 234(a)(6)(A), Revenue Act of 1921, ch. 136, 42 Stat. 255 (1921); § 234(a)(6)(A), Revenue Act of 1924, ch. 234, 43 Stat. 283 (1924). The text of the applicable statute is, however, clear enough. The law applicable to the distributions is the law in force in the years they took place, 1922, 1923 and 1925. The law in force in each of those years provided that "A stock dividend shall not be subject to tax." Section 201(d) of the 1921 Act and § 201(f) of the 1924 Act, note 5, *supra*. This explicit exemption from taxation fully satisfies the condition of § 115(1) that the distributions have been tax-free under the law in force at the time they were made.

To dispute this conclusion, plaintiff relies upon *Choate* v. *Commissioner*, *supra*, as holding that the distributions were taxable as income. The reliance is misplaced. *Choate* was a decision under § 115(f) of the 1936 Act (note 6, *supra*). Stock dividends were taxed, as far as constitutionally permissible, both by that Act and by its successor law, the 1939 Code (note 6, *supra*). Both statutes, however, were applicable

only prospectively (notes 6, 7, *supra*), and so neither can govern in determining whether the distributions in the 1920's were tax-free.

How clearly *Choate* depends on the prospective change made in the law by § 115(f) appears from this excerpt from the opinion (129 F. 2d at 688):

> In *Miles* v. *Safe Deposit & Trust Co.*, 259 U.S. 247, * * * it was said that rights issued to its common stockholders, to subscribe to a company's unissued common stock, are analogous to stock dividends. Such stock dividends were not constitutionally taxable under *Eisner* v. *Macomber*, 252 U.S. 189 * * *. But under § 115(f) stock dividends are now taxable so far as such a tax is constitutional, and so are rights to the extent that they are dividends. A stock dividend in preferred stock issued to common stockholders is, therefore, now subject to a valid tax.

The second condition for the application of § 115(1) is that the distributions have had the effect only of reallocating the basis of the stock originally held, as between the old stock and the new stock received in the distribution. Before 1936, when stock dividends were not taxed in the belief they were not constitutionally taxable, they were treated by the Treasury as having the effect only of a reallocation of basis as between the old and new stock. The practice was thereafter codified in § 214(e) of the Revenue Act of 1939, ch. 247, 53 Stat. 874 (1939).[12]

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[12] Section 214(e), in pertinent part, provided:

"(e) *Basis Under Prior Acts.*—The following rules shall be applied, for the purposes of the Revenue Act of 1938 or any prior revenue Act, as if such rules were a part of each such Act when it was enacted, in determining the basis of property acquired by a shareholder in a corporation which consists of stock in such corporation, or rights to acquire such stock, acquired by him after February 28, 1913, in a distribution by such corporation (hereinafter in this subsection called 'new stock'), or consisting of stock in respect of which such distribution was made (hereinafter in this subsection called 'old stock') if the new stock was acquired in a taxable year beginning before January 1, 1936, or acquired in a taxable year beginning after December 31, 1935, and its distribution did not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution:

"(1) The basis of the new stock and of the old stock, respectively, shall, in the shareholder's hands, be determined by allocating between the old stock and the new stock the adjusted basis of the old stock; such allocation to be made under regulations which shall be prescribed by the Commissioner with approval of the Secretary."

The authority for the proposition that the section is a codification of prior Treasury practice is no less than the House Committee which wrote the section. In reporting with approval what became § 214(e), the Committee said (H.R. Rep. No. 2894, 76th Cong., 3d Sess. 42–43 (1940)):

> Tax-free distributions in stock or in rights, whether or not constituting income within the meaning of the sixteenth amendment or exempt to the distributee under section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act, and tax-free distributions of stock or securities in a corporation a party to a reorganization, have consistently been treated by the Treasury as not resulting upon receipt in an increase in earnings or profits, but as causing the basis of the stock in respect of which the distribution was made to be allocated between such stock and the stock securities received, with the result that earnings or profits are increased, upon the sale of such stock or property, by the entire amount of the recognized gain computed upon the basis so determined by allocation. * * * [The section] explicitly states the rules heretofore applied by the Treasury.

Section 214(e), plaintiff says, cannot be applied, for it is by its terms limited to distributions which are not income (and, plaintiff would go on to say, the distributions here did create income). The portion of the section (note 12, *supra*) relied upon is this: "if the new stock was acquired in a taxable year beginning before January 1, 1936, or acquired in a taxable year beginning after December 31, 1935, and its distribution did not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution." The particular words invoked are: "and its distribution did not constitute income."

Plaintiff would read the last clause, beginning with "and," as applicable to acquisitions both "before January 1, 1936" and "after December 31, 1935." Such a reading is erroneous in that it overlooks the disjunctive effect of the "or" which insulates the condition "if the new stock was acquired in a taxable year beginning before January 1, 1936" from the remaining words, including the "and" clause, and leaves the category of acquisitions "before January 1, 1936" unaffected by the conditions placed on the acquisitions "after December 31, 1935." The section embodies a purposeful differentiation, which plaintiff would ignore, between the two stated classes of transfers—1935 and earlier, and 1936 and later. Plaintiff's view, were it accepted, would reduce the clause to a great many unnecessary words and phrases.

The words should rather be taken as if they were punctuated as emphasized in the following: "if the new stock was (*i*) acquired in a taxable year beginning before January 1, 1936, or (*ii*) acquired in a taxable year beginning after December 31, 1935, and its distribution did not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution." Punctuation of this type appears in a successor statute, § 113(a)(19)(A) of the 1939 Code, 26 U.S.C. § 113(a)(19)(A), added by § 214(a) of the Revenue Act of 1939, ch. 247, 53 Stat. 872 (1939). Properly read, the language of the section says that an acquisition before January 1, 1936, alone and without regard to the "and" clause, fulfills the condition for applicability of the section. The "and" clause is applicable only to the words, following the word "or," dealing with acquisitions after December 31, 1935.

Section 214(e), thus being applicable to the acquisitions in 1922, 1923 and 1925, serves to satisfy the second and last disputed condition of § 115(1)—that the dividend have an effect only on allocation of basis.

Accordingly, § 115(1) is operative, and directly forbids the inclusion in a recipient's earnings and profits of the value of the rights distributed in 1922, 1923 and 1925. Plaintiff is not entitled to recover on this issue in count 15 and in all of the counts in which it is raised.

V. LEASED LINE SUBSIDIARIES

Plaintiff owns all of the stock of the Oregon Short Line Railroad Company, approximately 99 percent of The St. Joseph & Grand Island Railroad Company and (together with Oregon) all of the stock of the Los Angeles & Salt Lake Railroad Company. A large part of the stockholdings was acquired soon after plaintiff's reorganization in 1898 and most of it has been owned by plaintiff for many years. The Oregon Short Line was acquired in exchange for shares in plaintiff

whose valuation is the subject of count 5; the stock in the latter two roads cost approximately $8 million.

During 1942 and for several of the years earlier, plaintiff operated substantially all of the properties of these subsidiaries under leases.[13] For practical purposes, the arrangement was a consolidation of railroad operations. Plaintiff paid all of the roads' expenses, including the expenses of maintaining their corporate existence and dividends on the publicly-owned 1 percent of the stock of The St. Joseph & Grand Island, and recorded in its books and reported in its tax returns all the income and expenses of the operations of the lines of the subsidiaries.

Equity invested capital, the basis on which plaintiff computes its excess profits credit, is under the 1939 Code subject to a reduction by the percentage of "inadmissible assets" among total assets. Sections 715, 720, Internal Revenue Code of 1939, 26 U.S.C. §§ 715, 720 (1952 ed.). An "inadmissible asset" is by Section 720(a)(1)(A) of the 1939 Code, as amended in 1941, defined to mean "[s]tock in corporations . . . except stock which is not a capital asset." Admissible assets are by section 720(a)(2) "all assets other than inadmissible assets." That is, while corporate stock held by a taxpayer entity is presumptively to be considered as a capital asset and as such "inadmissible" as an asset for purposes of invested capital, where the circumstances are such as make the stock a noncapital-asset, it becomes "admissible."

The ultimate question raised by count 18 is therefore whether or not the plaintiff's stock in these subsidiaries is to be treated as an "admissible asset" under Section 720 of the 1939 Code, and thus not be cause for any reduction of the plaintiff's invested capital. Resolution of the question depends on whether the assets are capital assets, which in turn is determined by whether the plaintiff acquired and holds the stock in the lessor roads for a business or for an investment purpose.

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[13] The subsidiary-lessors owned some stock which was not subject to the leases; on this stock they may have received some dividends. In the accompanying findings, it is found, at defendant's urging, that the lessors filed tax returns and could have (though they did not) paid dividends to plaintiff. These findings are however not material to the issue presented.

The parties are agreed that the legislative purpose was to make a non-capital-asset admissible, and thereby part of equity invested capital, when the income generated by it was includible in a taxpayer's excess profits net income. The simplest illustration of such an asset, prominent in the minds of the drafters of the relevant amendment of the section, is the corporate stock held by a securities dealer for sale to his customers. When such sales take place, there is generated ordinary excess profits net income, the committee reports said, "no different from any other article held for sale by a dealer." H.R. Rep. No. 146, 77th Cong., 1st Sess., 20 (1941); S. Rep. No. 75, 77th Cong., 1st Sess., 20–21 (1941); 87 Cong. Rec., Part 2, 1638 (1941). The regulations thus provide that the term "inadmissible assets" means "stock in all corporations, domestic or foreign, . . . except stock which is not a capital asset (such as stock held primarily for sale to customers by a dealer in securities)." Treasury Regulations 112, Sec. 35.720–1.

Litigation has produced illustrations of non-capital-assets other than the stock on the security dealer's shelf. One is stock in a restaurant, a going business, bought not for investment but to conduct a restaurant business by the use of the corporate assets, there having been some doubt as to the assignability of the lease of the restaurant premises. *John J. Grier Co.* v. *United States*, 328 F. 2d 163 (7th Cir. 1964). Another illustration, one of a number of cases involving stock bought as a source of inventory for regular business, is stock in a distillery, bought by a liquor dealer to obtain rights to purchase whiskey and sold promptly after the rights were exercised. *Western Wine & Liquor Co.* v. *Commissioner*, 18 T.C. 1090 (1952). A relatively recent case in this court involved stock in a manufacturer of yarn, held to be a noncapital-asset because it was bought by the taxpayer, a yarn sales agency, in order to obtain an extremely valuable source of supply of yarn. *Waterman, Largen Co.* v. *United States*, 189 Ct.Cl. 364, 419 F. 2d 845 (1969), *cert. denied*, 400 U.S. 869 (1970). *United States* v. *Mississippi Chemical Corp.*, 405 U.S. 298 (1972), does not make *Waterman, Largen* less authoritative.

The rule that emerges from the cases is that corporate stock which is held for a business purpose, that is, one intimately related to the taxpayer's normal source of business income, is not a capital asset. Stock not so related, and held for investment purposes, is a capital asset.

Plaintiff claims that the stock involved here meets the business purpose test for a non-capital-asset, in that plaintiff acquired and has held the stock in these subsidiaries in pursuance of its railroad operations, and not as an investment or speculation; that the operation of the leased lines was intended to produce excess profits taxable income, to be reported in plaintiff's return.

Plaintiff is upheld, and the issue is decided in favor of non-capital-asset status. The result is, however, not free from doubt. It is quite true, as the Government emphasizes, that the case of the securities dealer is far different from that of a leased railroad subsidiary. It is also true that decision in favor of plaintiff permits the money invested in a subsidiary to be treated as invested capital (and thus reduce excess profits taxes) twice, once as part of plaintiff's invested capital and again as part of the invested capital of the subsidiaries. Neither statute nor regulation, however, limits non-capital-asset status to the stock on the dealer's shelf.

The business-purpose-investment-purpose test is at best imprecise. Nuances of the application of the test could doubtless be discussed at length, and a case made for the Government's view, on the basis of the considerations it emphasizes. The consideration which to my mind tips the scales in favor of plaintiff's position is the historical evidence in this case of the intimate relationship of the subsidiaries to plaintiff's success as a railroad system. The loss of its subsidiaries prior to reorganization was a low point in the decline of the old Union Pacific Railroad, plaintiff's predecessor. The reacquisition of at least the Oregon Short Line was among the first thoughts for the future of the reorganizers and the new management. There can be no doubt that these subsidiary and connecting railroads, led by the Short Line, had great significance for the prosperity of the plaintiff as a transcontinental railroad system, in the years after it came out of reorganization in 1898. This significance appears in the course of the

discussion of the valuation of the shares issued in the reorganization for the old road and for the Oregon Short Line, in count 5.

With these origins, the acquisition of the stock cannot be treated as a mere investment unrelated to the business operations of the plaintiff. It was accomplished for an operating, business purpose and the stock was held as part of the operation of plaintiff's business as a railroad. If anything, the leases that followed confirm the conclusion of business and not investment purpose, even assuming that they were entered into only to reduce costs. As different as are a railroad and a restaurant, the case presented is in essence similar to the case of the restaurant stock, *John J. Grier Co.* v. *United States*, *supra*. The plaintiff bought the stock to run the railroad and not to make an investment, and thus the stock is a non-capital-asset "admissible" for purposes of equity invested capital under Sections 715 and 720. *Cf. Corn Products Refining Co.* v. *Commissioner*, 350 U.S. 46 (1955); *Booth Newspapers, Inc.* v. *United States*, 157 Ct. Cl. 886, 303 F. 2d 916 (1962).

Plaintiff is entitled to prevail on count 18.

VI. INTEREST ON 1948 AGREEMENT

Count 26 makes a claim for interest of over $12 million under a certain 1948 "cutback" agreement between plaintiff and the Commissioner relating to plaintiff's tax liabilities for 1942 and subsequent years. "Cutbacks" are refunds of railroad freight charges which have been paid by the Government. There is little or no dispute as to the facts; only a dispute as to their significance in the light of the agreement.

In transporting war material in 1942, when considerations of secrecy or the novelty of the material made it impossible to determine that a preferential, land-grant rate should be applied, plaintiff charged the Goverment the full commercial tariff. Thereafter, on audit by the General Accounting Office between 1943 and 1957 (delayed because of the great volume of auditing of wartime charges), the correct rates were determined, and plaintiff refunded the overcharges as they were determined. The refunds of overcharges for 1942 amounted to $12.8 million.

Plaintiff had accrued the full charges made in 1942 as income in that year and reported them as such in its tax return for that year. The charges having been received under a claim of right, income for 1942 could not be recomputed to exclude the amount of the refunds or cutbacks. Under normal tax procedures, the cutbacks could be treated only as deductions from taxable income in the years in which the cutbacks were paid over to the Government. *See Healy* v. *Commissioner*, 345 U.S. 278 (1953); *United States* v. *Lewis*, 340 U.S. 590 (1951). Large amounts of income, reported in years of high, wartime tax rates, were thus, by virtue of the delays in the audit, about to be reversed by reductions in income in postwar years of lower, peacetime tax rates.

In recognition of the prospective inequity, the Commissioner of Internal Revenue and the plaintiff agreed, on November 29, 1948, that normal practice would not be followed—that plaintiff would be permitted to allocate the amounts of the cutbacks not to the years of their payment but to the years in which the original charges had been included in taxable income. Accrued income for 1942, for instance, would be retroactively reduced by the amount of the cutbacks of rates included in income in that year and the cutbacks would be disallowed as reductions in income in the various years—1943 through 1957—in which they were actually made.

The letter from the Commissioner to plaintiff embodying this agreement, called the Cutback Agreement, stated as follows:

> In view of the facts and circumstances presented, permission is granted under the authority conferred in section 43 of the Internal Revenue Code to allocate, on the terms and conditions hereinafter stated, repayments heretofore or hereafter made of excessive transportation charges of the class described above to the years in which such charges were included in taxable income. However, the allocation of any such repayments of excessive transportation charges to any year shall be made only to the extent the refund or credit of the overpayment of income and/or excess profits tax, if any, resulting therefrom is not prevented for any reason, and the deficiency, if any, of income and/or excess profits tax resulting therefrom may be assessed.

The letter then goes on to set out the "terms and conditions" of the agreement, in numbered paragraphs:

> In this connection, it is understood that you agree, as follows:
>
> 1. All amounts received by you as transportation charges from the Federal Government Departments and Agencies shall be included in taxable income on the accrual basis.
>
> 2. All refunds of transportation charges made by you to the Federal Government shall be allowed as deductions in the year or years in which such transportation charges were included in income, and any deductions claimed in the year or years such refunds were made will be disallowed. * * *

The result of the permitted reduction in income for 1942 and the corresponding increase in income, distributed over 1943–1957, all other things being equal, would be an overpayment of tax for 1942 and underpayments in 1943–1957, and thus a refund for 1942 and deficiencies for 1943–1957. (This would all the more be true if, as seems to have been the case, plaintiff did not in the years following the making of the cutback agreement in 1948 cease its practice, in its tax returns, of reducing its annual income by the respective amounts of cutbacks made in those years.) And interest payable to plaintiff on the refund would exceed interest payable by plaintiff on the deficiencies, by reason of the longer span of time involved in the refund than in the deficiencies.

To relieve the Commissioner of such a net interest liability, the parties further agreed, in the Cutback Agreement, that the maximum interest payable to the plaintiff on a refund caused by the cutbacks should be limited to the amount of interest payable by the plaintiff on the deficiencies caused by the cutbacks, as follows:

> 3. The amount of interest on refunds of income and excess profits taxes resulting from these adjustments shall be allowed only to the extent of, and limited to, the amount of interest on deficiencies resulting from these adjustments.

Plaintiff's tax returns for 1942 were, as noted above, not finally audited until 1959. The tax years following 1942 are by reason of waivers still open; deficiencies for these years, re-

sulting from the cutbacks, have thus not been assessed, although they have been disallowed in revenue agents' reports for those years.

Plaintiff filed an excess profits tax return (Form 1121 under the 1939 Internal Revenue Code) for 1942 showing no liability; there followed certain additional payments by plaintiff in anticipation of a deficiency. (The precise amounts, and other details not here necessary, are set out in the accompanying findings of fact.) On audit, and after making general adjustments, the Commissioner computed a deficiency of $15.9 million unrelated to the cutbacks reduction in income.

The cutbacks reduction in income of $12.8 million, alone, would have resulted in an overassessment of $11.3 million. An adjustment attributable to cutbacks therefore required a deduction of $11.3 million from the deficiency of $15.9 million. When this adjustment was made, there remained a total proposed deficiency of $4.6 million, on which $.3 million in interest was payable, or a total assessed deficiency of $4.9 million.

Plaintiff's income and declared value excess profits tax return (Form 1120) showed a tax of $38.4 million. On audit, the Commissioner determined that liability for income tax was $30.4 million and that plaintiff had no liability for declared value excess profits tax. The consequent overassessment of income tax, with adjustments for certain subsequent assessments, was $7.9 million.

The computations for the two taxes were netted out as follows. The deficiency of $4.9 million in excess profits tax was satisfied by a credit of $4.2 million of the $7.9 million overassessment in income tax, and a certain postwar credit of $.7 million. This left $3.7 million due to plaintiff as the net balance of the $7.9 million overassessment of income tax, on which interest of $4 million was payable. The total, $7.7 million, was then paid to plaintiff.

The cutbacks had played a part only in the excess profits tax; the adjustment for cutbacks, the parties are agreed, had no effect on plaintiff's income tax. While the cutbacks of $12.8 million reduced plaintiff's 1942 income subject to income tax by that amount, the effect of the reduction was completely offset by the reduction of an allowable credit, under Section 26

(e) of the Internal Revenue Code of 1939, for income subject to excess profits tax.

There was, also, no connection between the cutbacks and the payment of the deficiency in excess profits tax by credit of a portion of the overassessment of income tax and the interest paid to plaintiff on the refund. It is agreed that the interest of $4.0 million, paid as part of the $7.7 million refunded to plaintiff, was attributable to the overassessment of income tax and was not related to the cutback adjustment or the interest in respect of cutbacks now claimed by plaintiff.

With the apparent complexities created by two tax returns stripped away, and, thereby, the income tax return, the refund of income tax and the interest thereon all set aside, the remaining relevant facts, all related to excess profits tax, are seen to be quite simple. The cutbacks reduced excess profits tax income and had there been no other factors the reduction would have meant an overassessment and a refund of excess profits tax of $11.3 million. Simultaneously, however, other items of income, not in question, increased income by a greater amount, which increase, alone, would have meant a deficiency of $15.9 million. When combined, the two adjustments resulted in a deficiency of $4.6 million. The actual tax liability figures were $18.807 million, on the basis of all adjustments except the cutback adjustment, and $7.484 million on the basis of all adjustments; the difference was the $11.3 million due to cutbacks. This sum was used to reduce the liability otherwise existing. In simplest terms possible, a tentative underassessment of $15.9 million, reduced by a tentative overassessment of $11.3 million due to cutbacks, produced a net actual underassessment and deficiency.

No refund was payable or paid. Since a refund, due to cutbacks or otherwise, was not made, no interest was due or payable. Interest is payable only on a refund. Hence plaintiff can have no claim to interest, at least on the basis of general tax law.

Plaintiff contends, however, that the Cutback Agreement took the payment of interest in connection with the diminution of income by reason of cutbacks "out of the normal process of assessment and collection," made it "subject solely to the provisions" of the Cutback Agreement, and required

the payment of interest on the overassessment of $11.3 million resulting from cutbacks.

The Cutback Agreement does no such thing. It displaces normal rules of assessment, collection and liability for interest on refunds only so far as the terms of the agreement go. And the terms of the agreement have a narrow effect upon interest. Paragraph 3, the only relevant provision of the agreement, does not in any wise provide for or require the payment of interest to plaintiff. It rather sharply limits payments of interest on refunds resulting from cutback adjustments. Interest to plaintiff on refunds resulting from cutbacks, it is provided, "shall be allowed only to the extent of, and limited to" the amount of interest payable by plaintiff on the deficiencies from the cutback adjustments in the to-be-assessed years of the actual refunds.

There is no limit put on the interest payable *by* the plaintiff. That was not the problem deemed needful of any agreement. The problem to which the paragraph is directed is that the large refunds to be expected for the war years, and the long span of time involved, would entail a large liability for interest to be paid by the Commissioner. The parties therefore provided in paragraph 3 that interest should be paid to plaintiff on refunds only in the amount of the interest paid by plaintiff on deficiencies.

The effect is to eliminate any payment of interest to plaintiff on refunds resulting from cutback adjustments. No actual payment of interest could be made *to* plaintiff until the limit on the payment becomes known, and when the limit—the amount of interest payable *by* plaintiff on deficiencies in the subsequent years—does appear, the cross-obligations wash out and nothing is payable to plaintiff.

A more fundamental reason for the failure of plaintiff's claims is that no refund was made and thus no interest was due, on general principles, unaffected by paragraph 3. Plaintiff seeks to overcome the fact of no refund by arguing that because the agreement required the Commissioner to refund an overassessment by reason of cutbacks, he should therefore not have wiped out the overassessment of $11.3 million resulting from cutbacks. To this plaintiff adds a complaint that its liability for interest on the deficiencies to be assessed for

1943–57 is still running, and that the Commissioner's action has deprived it of a fund of interest with which to minimize its interest bill on the future deficiencies.

Restated to include the relevant facts, the plaintiff's contention is that the agreement requires that interest be paid, as if on a refund, on the tentative overassessment of $11.3 million by reason of one item of income—the reduction in income by the cutbacks—though it was in the final computation wiped out by a larger underassessment of $15.9 million by reason of other items of income. So stated, the lack of merit becomes clear. Interest is payable only on the net, the refund, and not on individual items merged into the net refund. The overassessment of $11.3 million, by reason of the cutbacks, was required to be "wiped out" by the larger underassessment. The Cutback Agreement did not bear on the normal processes of audit and collection. In the paragraph of the agreement preceding the numbered paragraphs, quoted above, there is explicit recognition that the agreed-upon allocation of cutbacks to the year of the original overcharge might result in either "refund or credit." Here it resulted in a credit.

Had the Commissioner not applied the $11.3 million overassessment of excess profits tax resulting from the cutbacks to the $15.9 million deficiency, plaintiff would have been called upon to pay the $15.9 million deficiency resulting from adjustments other than cutbacks, instead of the actual deficiency of $4.6 million. Had plaintiff been granted its wish that it be paid interest for the years since 1943 on the $11.3 million overassessment, it could not have escaped liability for interest on the $15.9 million deficiency. In economic effect, therefore, plaintiff has received the interest on the $11.3 million which it is now claiming.

Finally, plaintiff complains of the continued running of its liability for interest on the deficiencies yet to be assessed. This is as it must be. The Cutback Agreement shows no sign of an intention to limit plaintiff's liability for interest; paragraph 3 limits interest paid *to* plaintiff, not interest to be paid *by* plaintiff. Interest on a deficiency compensates the Government for the withholding of the money. Since the time of the Cutback Agreement in 1948, the burden of continued accrual

of interest has been deliberately assumed by plaintiff, by its continuation of the practice of deducting the cutback amount from income in the year of the cutback, though the agreement contemplated deduction in the year of the original charge. Moreover, plaintiff could stop the running of interest by one method or another, all of which would involve payment.

The claim on the Cutback Agreement has no merit and plaintiff is not entitled to recover on count 26.

VII. 1898–1918 LAND SALES

This count 34 is one of those before the court as offsets to defendant's setoffs. 182 Ct. Cl. 103, 389 F. 2d 437 (1968). The facts needful to be stated for present purposes are few.

In count 34 a claim is made to include in plaintiff's income, and thus in earnings and profits for excess profits tax purposes, some $23 million received as gross proceeds of sales of land between 1898 and 1918.

The facts are these. Among the properties of its predecessor acquired by plaintiff in the 1898 reorganization were 6,577,000 acres of land in Colorado, Kansas, Nebraska, Wyoming and Utah. By 1919, plaintiff owned only 971,348.64 acres. It cannot be found that the entire difference, 5,604,942.85 acres, was sold, for lack of evidence as to the amount of land acquired in the intervening period, and because the figure for 1919 is one for non-carrier land. A great quantity of land was however sold.

Immediately after the reorganization, plaintiff had transferred the land to the Union Pacific Land Company, which it created for the purpose, in return for the stock and bonds of the Land Company. The bonds—$10 million in par value—were secured by a mortgage on all the Land Company's assets. The Land Company stock and bonds were then pledged by plaintiff as collateral under the first mortgage on plaintiff's own property.

This last mortgage provided that the net proceeds from sales of non-railroad land were to be paid to plaintiff to reimburse it for expenditures for betterments, improvements and equipment, exclusive of expenditures charged to operating expenses. Accordingly, the trustee paid over to plaintiff, between 1898 and 1918, $23,286,091.13, of his own total receipts of $23,392,717.22. On its books, plaintiff credited the sum received to its investment in road equipment account. No credit was made to income or surplus. The receipt of the money seems to have been simply the occasion for a credit to the investment account, that is, a decrease in the amount shown as invested.

No more is known than is set out above. We can only speculate on why the plaintiff's accountants and management omitted to show on the books as income or surplus the receipt from the trustee of what plaintiff now says was income. In any event, plaintiff did not in whole or in part record the receipt of the $23 million as income or surplus or as an addition to earnings or retained earnings and profits.

In its post-trial brief and requested findings of fact, plaintiff urged, from the foregoing facts (supplemented only by taking it as a fact that 5,604,942.85 acres of land were sold), that the original credit to the investment in road equipment account was error, and that the proceeds of $23,286,091.13 from the sale of 5,604,942.85 acres of land should now be included in its accumulated earnings and profits for excess profits tax purposes. No suggestion was made that a sum less than the $23 million might be earnings and profits; no findings were requested concerning a cost or basis for the lands claimed to have been sold for the $23 million.

In condensed fashion, plaintiff's case was this: land was sold for $23 million, and therefore that sum was income which belonged and belongs in accumulated earnings and profits, whatever the contemporaneous accounting treatment. Of course this is not the law. For one thing, gross proceeds of the sale of land are not gain or income; only the difference between sales price and cost or basis is realized income. Gross payments on bonds are not income; only the difference between payments and cost is realized income. Section 111, 1939 Code. And this is what the Government replied.

The Government in its reply also pointed out that plaintiff had failed to mention in its proposed findings or brief that $6,972,025.93 of the $23 million—the portion consisting of interest [14]—had already been included by plaintiff in its ac-

[14] The stipulated facts on the source of the trustee's receipts and the portion of these receipts represented by the $6.9 million are these:

(Continued)

cumulated earnings and profits for purposes of computation of its excess profits tax, and allowed by the Commissioner, and that this sum could hardly again be claimed.

On this, plaintiff abandoned the claim for $23 million. Admitting that it was entitled to treat as accumulated earnings and profits only the difference between sales price and basis, and admitting that it was not again entitled to the $6.9 million, it now claimed not $23 million, but $5 million. Specifically, it claimed, in newly requested findings proposing figures for each year from 1898 to 1916, that it had sold, for $9,987,507.94, 5,972,197 acres of land which had cost $6,533,664.62, with a realized gain of the difference, $3,453,843.32, and that the Land Company, a "wholly-owned subsidiary," had sold for $9,900,387.23, 3,620,615 acres of land which had cost $8,312,812.83, with a realized gain of the difference, $1,587,574.40. The request for these findings was filed with plaintiff's post-trial reply brief, 10 months after the date on which proposed findings were due and were submitted.

The newly proposed findings contain minutely detailed and varied contentions as to facts and practices over 50 years old. Entries on many pages of the books of account of the plaintiff, exhibits whose significance for this purpose had not been mentioned before, were cited to establish cost and sales prices for land parcels said to have been acquired and sold in the years 1898 to 1916.

Only one of the fatal defects in these proposed findings is that so far as can be determined plaintiff did not earlier give

(Continued)

Source	Amount	Part already included in plaintiff's earnings and profits
(1) Proceeds from sales by plaintiff of land and equipment	$2,381,588.36	----------
(2) Principal of deferred payments, interest thereon, and other receipts from lands of plaintiff less expenses	10,203,367.53	$1,231,264.60
(3) Interest received from U. P. Land Co. with respect to its bonds	5,713,967.20	5,713,967.20
(4) Amounts received from U. P. Land Co. in payment of its bonds	5,067,000.00	----------
(5) Interest on uninvested cash	26,794.13	26,794.13
Total	23,392,717.22	6,972,025.93

defendant notice of such contentions, on trial or in pretrial or at any other time in the many years in which the case had been pending.

In the pleadings, plaintiff had alleged and defendant denied that lands acquired on reorganization were carried on the books at no value and had been disposed of between 1898 and 1919 for $23,286,091.13, which had been erroneously credited to investment in road and equipment and not credited to accumulated earnings and profits. Only the acquisition of lands in the reorganization was admitted.

All the pretrial papers exchanged by the parties—statements by each party of its contentions of law and facts, statements by each party of the controverted facts it proposed to prove and a joint statement of the issues which identified the documents and witnesses with respect to each issue—show on the one hand that plaintiff claimed a zero basis for all the land sold, and on the other hand that defendant never retreated from its denial of the claimed zero basis and from its positions that income is realized only to the extent of the difference between gross receipts and cost, and that plaintiff realized no income from the land transactions beyond the sums (the $6.9 million) already included in accumulated earnings and profits.

These pretrial papers were exchanged and filed as part of extraordinarily extensive pretrial proceedings, which took place under pretrial orders providing that facts, issues and witnesses not proposed, stated or disclosed by a party prior to trial would not be permitted to be proved, raised or called on the trial, except as required by the exigencies of the case. The exigencies of the case most emphatically do not require that plaintiff, having failed in pretrial and trial to mention the facts, contentions and issues it now relies upon, be permitted to raise these issues for the first time after trial, in a reply brief, long after the time for requested findings has expired.

Plaintiff has until now been committed to a zero basis, which it apparently intended to prove as a matter of law by the arguments and testimony relating to its accounting practices in the opening years of the century concerning retirements of equipment. These were the arguments and testimony

which it relied upon in count 8, concerning $13 million deducted from income in those years and credited to investment account. For this position, plaintiff would now substitute a new theory, on new facts, on newly requested findings. It is too late. The disorder of permitting such a step and the consequent prejudice to defendant are unthinkable.

It may be added that even were plaintiff's proposed findings to be considered, they could not be adopted. As might be expected from extemporized findings, the record does not support what plaintiff sets out to prove—the acreage on hand and its cost, the acreage acquired and its cost, and the acreage sold and its proceeds, for plaintiff and the Land Company, for each year from 1898 to 1916. Figures are lacking for major elements in the purported chain of proof; projections and assumptions, offered to fill in the gaps, are hopelessly insufficient. For instance, the proposed figures for gross proceeds are often only contract sale prices, and the lands acquired are often lands surrendered by deferred payment purchasers. Another type of defect is the inconsistency between the new contentions, which ignore the Land Company's bonds, and the earlier position of plaintiff, already imbedded in its tax returns, that this is a case of income from the holding and redemption of bonds.

On the failure of the newly proposed findings, one short statement of this whole affair could be that a basis for the lands sold has not been shown and thus no income is provable. Another is that plaintiff fails to overcome the force of its own books. The crediting of the proceeds to investment in equipment and the failure to credit income and thus add to surplus or earnings or profits, as inexplicable as they may be on looking backwards, were the deliberate choice of plaintiff's management and accountants. As the Interstate Commerce Commission said in connection with the deductions from income involved in count 8, some purpose must be ascribed to the accountants who made up the books. Plaintiff has the burden of proof when it undertakes to show otherwise than is said in its books. For lack of proof of error or meaninglessness, these entries cannot be undone after they have existed for half a century.

Plaintiff is not entitled to prevail on count 34.[15]

VIII. UNAMORTIZED BOND DISCOUNT AND EXPENSE

When a corporation sells bonds at less than their face value, *e.g.*, 20 year 4 percent bonds with a $1,000,000 face value for $950,000, the difference between the face value and the proceeds, or in the illustration $50,000, is called bond discount. (If the bonds are sold at more than face value the excess is called premium.) The expenses of the issue, say $10,000, which reduce still further the net proceeds of the issue, are called bond expense.

By the customary accounting treatment the $1,000,000 payable at maturity goes on the right or liability side of the corporate balance sheet. The $940,000 net proceeds go into cash, and are recorded on the left or asset side. Where shall the $60,000 in bond discount and expense go? It will have to be paid at maturity, one way or another, and it will have to be defrayed, somehow, from income or capital. One type of treatment is to charge it off immediately against surplus, and this is how plaintiff recorded on its books, presumably in accordance with ICC regulations, the bond discount and expense arising from its sales, in its early years, of bonds at a discount. Another method, the approved income tax treatment, call for a systematic annual charge against income of a ratable portion, over the life of the bonds, and this is what plaintiff did in its tax returns. *Helvering* v. *Union Pacific R.R.*, 293 U.S. 282 (1934).

The question here presented by additional defense is whether unamortized bond discount and expense, remaining in the years 1940 through 1942 after plaintiff's earlier income tax deductions, was correctly treated by plaintiff as an asset for purposes of the excess profits tax, more specifically, for

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[15] With respect to additional defenses 7, 8 and 18, the plaintiff has agreed that, to the extent defendant establishes that certain income was realized subsequent to March 1, 1913, plaintiff withdraws the amounts so established from plaintiff's accumulated earnings and profits. Since such a finding has been made as to the amounts of $375,974.45, $566,431.20 and $13,228.89, whose total is $955,629.54, this latter sum shall be excluded from plaintiff's accumulated earnings and profits, and to this extent defendant is entitled to prevail on additional defenses 7, 8 and 18.

purposes of the reduction in equity invested capital by the percentage of inadmissible assets among total assets, required by sections 715 and 720 of the 1939 Code as amended, 26 U.S.C. §§ 715, 720 (1952).

While the Commissioner of Internal Revenue did not disturb plaintiff's treatment of the sum as an asset, the Government here challenges the propriety of such treatment, in an additional defense, No. 9, by way of a setoff. The amount involved for 1940 through 1942, in excess profits tax credit for 1942 and in credit carryovers from prior years, is $11,526,629, of which $10,355,828 is bond discount and $1,170,801 is bond expense.

The Government is here upheld in its position that unamortized bond discount and expense is not an asset for purposes of the cited sections.

Unamortized bond discount has none of the characteristics of an asset, except for its position on the left side of the ledger. It is essentially interest—the cost to the borrower of the borrowed money or the compensation paid for the use of the borrowed money—and it is to be amortized until maturity of the bonds, and then paid. *Helvering* v. *Union Pacific R.R.*, *supra*. The unamortized portion, interest not yet paid, is patently not an "asset," whatever be the definition of that seldom construed term.[16]

The origins of bond discount determine its character as a reflection of interest rates—real or market and nominal. The corporation which so chooses can simply sell its bonds or other obligations at the market rate of interest and encounter no discount. When, however, an issuer desires to sell bonds which will bear on their face a lower rate of interest than that which will cause the bonds to be bought, it perforce must set the price of the bond lower than maturity value. The buyer is offered, in addition to the face rate of interest per annum, the

[16] There is little authority on the definition of assets for purposes of excess profits taxes. It is held that treasury stock is not an asset for purposes of the use of the term in the definition of equity capital in section 437(c) of the Excess Profits Tax Act of 1950, 26 U.S.C. § 437(c) (1952 ed.). *Colt's Manufacturing Co.* v. *Commissioner*, 300 F. 2d 929 (2d Cir. 1962); *Penn-Texas Corporation* v. *United States*, 158 Ct. Cl. 575, 308 F. 2d 575 (1962). And an asset has been described, in the context of the excess profits tax for 1919, as an item valuable and used in the taxpayer's business. *Isbell Porter Co.* v. *Commissioner*, 40 F. 2d 432 (2d Cir. 1930).

difference between face value and sales price in the form of a lump sum at maturity. This difference is called discount. The yield to the buyer takes two forms—the nominal coupon rate and the deferred lump sum.[17]

Both forms, together called effective interest, are costs to the issuer of the borrowing and compensation to the lender for the loan. Both must be found by the issuer and paid to the lender. Coupon interest is paid annually from income. Discount is accumulated annually (the term "accumulation" is, by accounting authorities, preferred to "amortization"), from income, and paid over at maturity. If the coupon rate, payable annually, is interest, then the lump sum payment, the product of annual accumulation, is also interest.

The income tax treatment of discount—accumulation of the total discount by a charge of a ratable portion against income in each year of the life of the bond—is a recognition of the reality that discount is in essence the same as coupon interest, and that each is a cost of the borrowing to be charged annually against income in the years of the borrowing. The unaccumulated, to-be-charged-against-income interest represented by the remaining years' coupons is of course not an asset, and the similarly unaccumulated to-be-charged-portion of effective interest represented by unamortized bond discount is, therefore, equally not an asset. Interest, payable this

[17] "Bond discount is defined as the excess of face or maturity value over the amount of cash or equivalent paid in by the original bondholder, and, conversely, premium is defined as the excess of cash paid in over maturity value. The explanation of this excess lies in the fact that, in the discount case, the nominal or 'coupon' rate of interest stated on the bond is less than the market or effective rate. In this case the investor is unwilling to pay maturity value for the bond, since this price would yield only the coupon rate. Instead, the price of the bond is set at some lower point where the yield to the buyer is the same as the market rate of interest on comparable securities. In the case of a premium, the coupon interest rate exceeds the market rate, and the price of the bond is set at a point above maturity value that will yield to the investor only the market rate of interest." R. Wixon, W. G. Kell, & N. M. Bedford, *Accountants' Handbook* (5th ed. 1970) 20.30.

"Authorities generally agree that bond discount should be charged systematically to income as interest expense over the life of the bond issue." *Ibid.*, 20.37.

"Bonds are sold at a discount because the rate of interest specified in the indenture is less than the rate that the issuing company must pay for the use of money. This discount, together with the expense of issue, is customarily charged to unamortized debt discount and expense and written off over the period from the date of issue to the date of maturity of the bonds. The sum of the interest paid and the amortization of debt discount, by periods, represents the effective rate of interest on the outstanding bonds." N. J. Lenhart & P. L. Defliese, *Montgomery's Auditing*, 311 (8th ed. 1957).

year or next or to be set aside year by year and paid at a fixed future date, is not an asset.

Judicial, administrative and accounting authority recognize that bond discount is interest. Discount is held to be deferred interest, "likely to arise when the stated rate of interest on the obligation is less than the rate demanded by the market. *American Smelting and Refining Co.* v. *United States*, 130 F. 2d 883 (3d Cir. 1942) * * * [E]conomic and business reality * * * recognizes that to the issuer bond interest is reflected both by the stated rate of interest and by the amount below or above par received by the issuer when the bonds are originally distributed." *Atchison, Topeka and Santa Fe R. Co.* v. *United States*, 443 F. 2d 147, 151, 153 (10th Cir. 1971).

An early, leading decision of the Securities and Exchange Commission held discount to represent "additional interest," "part of the cost which the issuer must eventually pay for the use of the funds." The Commission noted that "[a]ccounting authority recognizes that bond discount should be considered as part of the interest cost of the capital obtained." *In Re Alleghany Corporation*, 6 SEC 960, 962 (1940). The American Institute of Certified Public Accountants, in a 1961 reissue of earlier research bulletins entitled "Unamortized Discount, Issue Cost, and Redemption Premium," is to the same effect.[18]

The attempted characterization of unamortized bond discount as prepaid interest and the likening of it to prepaid

[18] "1. Until the early days of the century, bond discount was commonly regarded as a capital charge. When the unsoundness of this treatment was recognized, alternative methods of treatment became accepted, under one of which the discount was distributed over the term of the issue, and under the other the discount was charged immediately against surplus, the latter being regarded generally as the preferable course.

"2. Present-day treatment recognizes that on an issue of bonds the amount agreed to be paid (whether nominally as interest or as principal) in excess of the net proceeds constitutes the compensation paid for the use of the money. Where bonds are issued at a discount it is customary to distribute the discount over the term of the bond issue and to charge both the coupon interest and the allocated discount directly to income.

"3. In the committee's opinion it is a sound accounting procedure to treat such discount as a part of the cost of borrowed money to be distributed systematically over the term of the issue and charged in successive annual income accounts of the company. * * *" American Institute of Certified Public Accountants, ACCOUNTING RESEARCH AND TERMINOLOGY BULLETINS (1961) ch. 15, *Unamortized Discount, Issue Cost, and Redemption Premium on Bonds Refunded*.

insurance or rent is without basis. Discount represents the portion of the face amount of the bonds not received by the debtor, an amount owed and to be paid on maturity. It is more a nonreceipt, an unpaid cost or charge, a liability or a deferred loss, a deficit or an offset to maturity value, than an asset. Prepaid insurance or rent has been paid, could be refunded and will save an expenditure of equal amount in the time to come. Unamortized bond discount has not been paid, is a liability and remains to be expended in the future.[19]

The custom of recording unamortized bond discount on the left side of the balance sheet, even had plaintiff followed it, gives no support to the notion that it is an asset. Expert testimony in the record, made the basis for one of the accompanying findings of fact, is that unamortized bond discount and expense is put on the asset side of the balance sheet "solely to make the balance sheet balance." Double entry bookkeeping and its compelled symmetry may not alter the nature or control the tax treatment of financial realities. *Doyle* v. *Mitchell Brothers Co.*, 247 U.S. 179 (1918); United Profit-Sharing *Corp.* v. *United States*, 66 Ct. Cl. 171, 182 (1928).

Percipient auditors have long recognized that not everything that appears on the left side of the ledger warrants the caption "asset." Robert H. Montgomery, a leading authority, writing that bond discount was not an asset but a deferred loss, attributed its inclusion among assets to the "curse of balancing." Despairing of the acceptance of a realistically unbalanced balance sheet, he suggested changing the balance

[19] "[The argument t]hat bond discount should be interpreted as prepaid interest and therefore deserves recognition as an asset similar in nature to prepaid insurance or rent * * * has no logical justification. Bond discount, far from being prepaid interest, represents unpaid interest, or that portion of effective interest that will not be paid until the bond matures. No payment of interest has occurred. The issuer has simply borrowed less than the maturity value of the bonds." R. Wixon, W. G. Kell, & N. M. Bedford, *Accountant's Handbook, supra* note 15, 20.34.

"Especially objectionable is the practice of labeling discount on bonds or notes—the difference between actual proceeds and the amount due at maturity—as 'prepaid interest,' and this treatment requires further comment. * * * In the case of a loan effected at a discount the borrowing company actually makes no advance or prepayment whatsoever. Far from being "prepaid" interest the amount of the discount represents *unpaid* or future interest—that portion of the total interest which is not paid until the date of maturity." W. A. Paton, *Advanced Accounting* (1941) 611–12 (emphasis in original).

See also D. J. Dohr, *What Is An Asset*, 73 J. of Accountancy 213, 216–17 (1942).

sheet heading to "Assets etc." and making discount on bonds an "etc." R. H. Montgomery, *The Curse of Balancing, or Theory v. Practice*, 63 J. of Accountancy 279 (1937). Professor W. A. Paton, another authority, concurs in the opinion that bond discount is not an asset.[20]

Plaintiff would support its claim that unamortized bond discount is an asset by the charge-off, on its books, of the entire amount of the discount to surplus, at the time the bonds were first issued. Such accounting for bond discount and expense, while doubtless proper under ICC regulations, is in disfavor with the accounting profession and is not proper tax practice. The profession prefers [21] and the tax law requires the systematic charge to income over the life of the bonds.

[20] "One of the least excusable of the standard practices of accounting is that which treats bond discount on the issuer's books as an asset either related to such current balances as unexpired insurance and prepaid rent or as a long-term deferred charge allied to organization cost. Unaccumulated discount on a bond or similar security is in no sense an asset, but represents an element of the total 'interest' charged during the life of the contract. The discount is the difference between the amount of the actual capital received from the investor and the par or face value—the amount payable at maturity. It is neither a prepayment of cost by the borrower nor income received in advance by the investor; it is rather that portion of the effective interest which remains unpaid by the corporation and uncollected by the bondholder until the due date of the security." W. A. Paton, *Advanced Accounting, supra* note 17, 608–9.

[21] "The anticipation of this income charge [bond discount] by a debit to income of a previous year or to surplus has in principle no more justification than would a corresponding treatment of coupons due in future years.

"4. The argument advanced in favor of immediately writing off discount was that it extinguished an asset that was only nominal in character and that it resulted in a conservative balance sheet. The weight attached to this argument has steadily diminished, and increasing weight has been given to the arguments that all such charges should be reflected under the proper head in the income account, and that conservatism in the balance sheet is of dubious value if attained at the expense of a lack of conservatism in the income account, which is far more significant." The American Institute of Certified Public Accountants, ACCOUNTING RESEARCH AND TERMINOLOGY BULLETINS (1961) ch. 15, *Unamortised Discount, Issue Cost and Redemption Premium on Bonds Refunded*, note 16, *supra*.

"If discount on bonds issued is charged directly to income or surplus as a loss the immediate effect is to understate the proprietary equity and the later effect is to free the income statements through the life of the bonds from a portion of the true interest burden. This procedure, accordingly, results in a continuing error, in both statements, from the time the bonds are issued until date of payment." W .A. Paton, *Advanced Accounting, supra* note 17, 610.

"Irregular absorption of discount or premium, such as is permitted under the accounting rules of the Interstate Commerce Commission, is unsatisfactory. Failure to accumulate or to amortize until date of maturity is still more objectionable. If discount is not accumulated until date of payment this means that there has been no recognition of the increase in the bond liability from issue price to maturity value—that profits have been overstated because of failure to include accruing discount in interest charges. It then becomes necessary to accrue the entire amount of discount at one stroke by a charge to income or surplus, and if income and surplus are not available in sufficient amount the result is a deficit. Similarly, if premium has not been amortized this means that there has been no recognition of the decreasing liability from issue price to maturity value—that profits have been understated throughout the life of the business by failure to exclude from interest charges the amortization of premium. It then becomes necessary to credit the entire amount of premium to income or surplus in one figure as a belated correction of the proprietary equity." *Ibid.*, 621.

"Under current generally accepted accounting principles, bond discount and expense should be written off over the life of the issue by periodic charges against income. In the past, debt discount and expense was often charged off to earned surplus at the date of issue, or at a later date; this procedure is no longer acceptable." N. J. Lenhart & P. L. Defliese, *Montgomery's Auditing, supra* note 15, 311–12.

The source of both the professional preference and legal requirement for an annual charge to income is the character of bond discount as interest, a cost of borrowing, and the consequent feeling that both types of interest—coupon interest and the discount variety—should equally be reflected in the income account by an annual expense item, else income is overstated. An immediate write-off against earned or paid-in surplus, in effect a charge to past income or to capital, is an over-statement of income by the annual cost of the borrowing. Plaintiff's charge of the entire discount to surplus was thus inconsistent with the nature of discount and cannot give grounds for characterizing it as an asset.

In a final effort to show that discount is an asset, plaintiff urges, with support in the expert testimony given on trial, that the unamortized portion of bond discount would have value to a purchaser of the business, as a source of future tax deductions. Such value is surely limited. Unamortized discount would have no value to a purchaser of the assets, no weight to a lender considering a loan. It has not been bought or paid for, it produces no income and it could not be sold or assigned. The value it might have to a purchaser of the going business, as a source of income tax deductions, could only be realized if profits were made by the use of the admitted assets of the enterprise. That purchase, moreover, would find the same "value" in the obligation to pay the fixed, coupon rate of interest, which like the annual accumulated share of discount, must each year be a charge on income. Discount, actually a cost to be defrayed in the years to come, has the same

type of value, as a source of income tax deductions, as the corporation's contracts with its executives, the lease of its premises, its pension plan, or, for that matter, a large tax loss carried over from past years. All give rise to tax savings. Since such "value" does not make an asset of next year's tax loss, it cannot transform unamortized bond discount from unpaid interest to an asset, at least for purposes of an excess profits tax based on concepts of invested capital and total assets.

There remains the unamortized bond expense. It, too, must be regarded as is unamortized bond discount—as a non-asset.

Bond issuance expense may differ factually from bond issuance discount, in that expenses are actually paid out for services such as printing, legal fees and commissions, and, sometimes or always to an extent, are paid out by the issuer itself as distinguished from the issuer's underwriter. Accordingly, some accounting authorities distinguish between discount and expense, and hold the latter to be a genuine asset.[22]

If the question were open for fresh decision, perhaps the unamortized portion of bond expense paid out by the issuer (as distinguished from expenditures for services by underwriters which merely reduce the proceeds of sale paid over to the issuer) might be held to be an asset. Plaintiff has, however, failed to show that the bond issuance expenses here involved were of any different character than those held in

[22] "It is common practice to lump actual discount with the legal fees, printing costs, underwriting commissions, and other charges associated with the issuing of bonds, but this is not good accounting. The various service costs which must be incurred in raising capital are a genuine asset (not a money fund but a legitimate cost factor) and should be dealt with accordingly. Where such costs are incurred in issuing a terminable security it is reasonable to assume that their significance expires during the life of the security, and complete amortization in this period is therefore indicated." W. A. Paton, *Advanced Accounting, supra* note 17, 612.

"Charges connected with the issue of new bonds—such as legal expenses in preparing the bond contract and mortgage, cost of printing certificates, registration costs, commission to underwriters, etc.—are costs of the use of capital obtained for the whole life of the issue and should be written off over that period. * * *

"It is common practice to lump these costs with actual discount (or net them against premium, as the case may be). Good accounting requires careful distinction between a true asset and bond discount, which is properly an offset to the maturity value of the bonds." R. Wixon, W. G. Kell, & N. M. Bedford, *Accountants' Handbook, supra* note 17, 20.39.

Helvering v. *Union Pacific R.R. Co.*, *supra*, to be as much interest as bond issuance discount.[23]

In *Helvering* v. *Union Pacific R.R. Co.*, the Supreme Court held that commissions paid out on the issuance of bonds, one of the customary bond issuance costs, were to an accrual taxpayer (as is the instant plaintiff) to be capitalized, amortized over the life of the bond and the amortized amount deducted annually from income. The decision has been applied in this court to bond issuance costs generally. *Chicago, Milwaukee R. Co.* v. *United States*, 186 Ct. Cl. 250, 262, 404 F. 2d 960, 967 (1968).

The Supreme Court in its opinion said that discount and expense were both "factors in arriving at the actual amount of interest paid for the use of capital procured by a bond issue" which "must be added to the aggregate coupon payments in order to arrive at the total interest paid." 293 U.S. at 286. The Court went on as follows (293 U.S. at 286–87):

> But even if the commissions, unlike discount, may, as the Government insists, be regarded as a contemporary expense of procuring capital, it is one properly chargeable to capital account. In practice it is taken out of the proceeds of the bonds by the banker. But in any case it must be deducted from the selling price to arrive at the capital realized by the taxpayer from the sale of the bonds, in return for which he must, at maturity, pay the face value of the bonds. The effect of the transaction in reducing the capital realized, whether through the payment of commissions or the allowance of discount, is the same. * * *
>
> Here the commissions, when paid, were properly chargeable against capital, and reduced by their amount the capital realized by the taxpayer from the bond issue. They come out of the pocket of the taxpayer only on payment of the bonds at maturity. But, unlike the purchase and sale of property, the transaction contemplated from the beginning a fixed date, the due date of the bonds, at which the difference between the net amount of

[23] The burden of proof on the issue, though raised by defendant's setoff, is on the plaintiff-taxpayer, for the contested issue is obviously one of substance and is involved in the very tax return on which plaintiff seeks a refund. *Missouri Pacific Railroad Co.* v. *United States*, 168 Ct. Cl. 86, 338 F. 2d 668 (1964).

capital realized upon the issue and the par value of the bonds must be paid to bondholders by the taxpayer. * * *.

Given the Supreme Court's ruling on the essential sameness of discount and expense, albeit in an income tax case, the decision in the instant case can only be that expense goes with discount, and since discount is surely not an asset, expense, too, is not an asset.

Accordingly the defendant is entitled to prevail on additional defense 9.

IX. DISCOUNT AND PREMIUMS

In additional defense 6, also involving bond discount and expense, the Government contends that plaintiff erroneously failed to treat as "interest," under section 711(a)(2)(B) (26 U.S.C. § 711(a)(2)(B) (1952)), amortized bond discount and expense for 1940–42 (excess profits tax credit carryovers for 1940 and 1941 are involved, in addition to 1942 taxes), and call premiums and unamortized bond discount paid out when certain bonds were retired in 1940 at their face value plus a premium, as required by their terms on an early retirement.

Under section 719(b) (26 U.S.C. § 719(b) (1952)) only 50 percent of borrowed capital may be included in invested capital and, consistently, when invested capital is the method used (as it is here) to determine the excess profits credit (which in turn is the basis of the tax), interest deductible from excess profits net income is required by section 711(a)(2)(B), supra, to be reduced by 50 percent of the interest on borrowed capital. In other words, since only half of borrowed capital may be included in invested capital for purposes of the credit, only half of the interest paid on borrowed capital is allowed to be deducted from income for purposes of this tax. See *Amana Refrigeration, Inc.* v. *United States*, 152 Ct. Cl. 406, 410, 285 F. 2d 770, 772 (1961).

Plaintiff and its subsidiaries deducted in full—that is, did not reduce by 50 percent—a certain sum of $10,253,706.34, composed of $546,273.70, the amount of amortized bond discount and expense in the tax years 1940–42, $3,265,051.46, the amount of unamortized bond discount remaining in 1940, the

year of the retirement of a certain bond issue, and paid on the retirement, and $6,442,381.18, the call premium paid in that year on the retirement.

In additional defense 6, defendant contends that these deductions were all for "interest" and pursuant to section 711(a)(2)(B) must be halved. Plaintiff maintains, to the contrary, that amortized discount and the call premiums were ordinary and necessary business expenses under section 23(a) of the 1939 Code, and that the unamortized bond discount on the bonds reacquired at face value plus call premiums was a loss under section 23(f) of the 1939 Code.

The regulations provide that on retirement of bonds issued at a discount the excess of the price paid over the issue price plus the amount of discount already deducted is a deductible expense. Treas. Reg. 111, § 29.22(a)–17(3) (1943). The regulations are not helpful in determining whether the amounts are deductible as "interest."

Bond discount has already, in the preceding section of this opinion, been noted to be essentially interest. *Helvering* v. *Union Pacific R.R.*, 293 U.S. 282, 286 (1934). See *Erie Lackawanna R.R.* v. *United States*, 190 Ct. Cl. 682, 686, 422 F. 2d 425, 427–28 (1970). To the seller the difference between the discounted purchase price of a promissory note and the higher sale price is held to be ordinary interest income. *United States* v. *Midland-Ross Corp.*, 381 U.S. 54 (1965). The precise question has been several times decided, in favor of the Government. Discount has repeatedly been held to be interest under section 711(a)(2)(B) or its successor in the Excess Profits Tax Act of 1950, section 433(a)(1)(O), ch. 1199, 64 Stat. 1137, 1143, 26 U.S.C. § 433(a)(1)(O) (1952). *Central Stations Signals, Inc.* v. *Commissioner*, 10 T.C. 1015, 1020–21 (1948), *affirmed per curiam*, 174 F. 2d 479 (2d Cir. 1949) (finance charge for factoring contract held interest under section 711(a)(2)(B) and not expense); *Warner Co.* v. *Commissioner*, 11 T.C. 419, 432 (1948), *affirmed per curiam*, 181 F. 2d 599 (3d Cir. 1950) (amount of state tax on loans, imposed on bond purchaser but paid by issuer in addition to interest, held interest under section 711(a)(2)(B) and not a tax); *L–R Heat Treating Co.* v. *Commissioner*, 28 T.C. 894, 897 (1957) (negotiated bonus for loan withheld by lender

from loan proceeds, in addition to 6 percent interest, held interest under 26 U.S.C. § 433(a)(1)(O) (1952 ed.); *Ringmaster, Inc.* v. *Commissioner*, August 6, 1962, T.C. Memo 1962–187, 21 TCM 1024, 1030–32, *dismissed per curiam*, 319 F. 2d 860 (8th Cir., 1963) (amounts paid as commissions for securing loans held interest under § 433(a)(1)(O), not brokerage fees).

The amounts of bond discount already amortized are thus to be deducted as interest. It may well be that an interest expense is also an ordinary and necessary business expense, but it is interest on borrowed capital and thus within the intent and subject to the reach of section 711(a)(2)(B).

Unamortized bond expense on bonds reacquired, and call premiums payable and paid at such retirement prior to maturity, are no different in principle from amortized bond discount. When an issuer sells bonds at a discount, the entire difference between issue price and face value is interest, to be paid at maturity, and to be charged to income each year and accumulated over the life of the bonds. Whether the bonds are early retired, pursuant to the terms of the issuance, by payment of face value plus a call premium, or are retired on maturity by payment of face value alone, there is no distinction to the lender or borrower between the constituent parts of the amount of discount on the loan.

What has been said indicates that call premiums, too, are additional interest, in this case payable for the privilege of converting a longer term loan to a shorter. A payment closely similar to a bond call premium, a charge paid by a borrower when he prepays, before maturity, the principal of a mortgage or promissory note, has been held in this court to be "interest" gross income to an insurance company. In *Equitable Life Assurance Society* v. *United States*, 149 Ct. Cl. 316, 319, 181 F. Supp. 241, 242, *cert. denied*, 364 U.S. 829 (1960), the court held:

> The precise question before us was considered by the Tax Court in *General American Life Insurance Company*, 25 T.C. 1265 (1956). That court decided that prepayment charges are in reality an additional fee for the use of the lender's money for a shorter period of time than originally agreed upon, and that this fee represents the generally higher cost of a short-term, as opposed to a

> long-term loan. The charges are part of the compensation to the lender for the use of money. *Deputy* v. *duPont*, 308 U.S. 488, 498; *Old Colony R. Co.* v. *Commissioner*, 284 U.S. 552, 560–61. They are thus directly related to the economic cost of borrowing money and are not merely incidental to the loan transaction, but fall within the statutory term "interest."

See also *The Prudential Insurance Co. of America* v. *United States*, 162 Ct. Cl. 55, 65–66, 319 F. 2d 161, 166–67 (1963); *United Benefit Life Insurance Co.* v. *McCrory*, 242 F. Supp. 845, 850–51 (D.C. Neb., 1965) (penalty payment for early repayment of mortgage held interest income of life insurance company). Contrary dicta in *Central & South West Corp.* v. *Brown*, 249 F. Supp. 787 (D.C. Del., 1965), cannot prevail over the cited authorities.

There would be no rational basis, in the light of the essential sameness of character between discount and call premiums, for holding one to be and the other not to be interest under section 711(a)(2)(B). The sums over the original amount of the loan constitute compensation for the use of the money—interest—payable when the loan is repaid, whether earlier than contemplated or on schedule. The early repayment is for the convenience of the borrower and works no change in the nature of the payment as interest. The decision here is, I believe, all but concluded by the decision of this court that difference between agreed redemption price and issue price (in a case of non-interest-bearing debentures redeemed a year after issue) is income "in lieu of the payment of interest," because it constituted "the agreed compensation for the use of the purchaser's money for the prescribed periods." *Pattiz* v. *United States*, 160 Ct. Cl. 121, 127–28, 311 F. 2d 947, 950 (1963). If part of that difference is a loss, it is a loss which is in the form of additional interest payable for the privilege of early retirement. *Cf. Helvering* v. *Union Pacific R.R.*, 293 U.S. 282, 286 (1934).[24]

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[24] Both commissions and discount, as the Government concedes, are factors in arriving at the actual amount of interest paid for the use of capital procured by a bond issue. The difference between the capital realized by the issue and par value, which is to be paid at maturity, must be added to the aggregate coupon payments in order to arrive at the total interest paid. Both discount and commissions are included in this difference. If the difference be viewed as a loss resulting from the funding operation, it is one which is realized only upon the payment of the bonds at maturity."

Against the foregoing wealth of authority, plaintiff puts forward only inferences from the legislative history of a nearby section, section 711(b)(1)(D), added by section 201 of the Second Revenue Act of 1940, ch. 757, 54 Stat. 974, 26 U.S.C. § 711(b)(1)(D) (1952). Section 711(b)(1)(D), not involved in the instant case, disallows certain deductions from taxable income of expenses and losses on the retirement or discharge of bonds, issued at a discount and outstanding for more than 18 months, in computing excess profits income for base period years beginning before January 1, 1940, the computation of which is necessary where the excess profits credit is based on average income rather than invested capital.

The House bill which became section 711(b)(1)(D) read much as does the section in final form, and affected only the computation of excess profits net income for base period years, not here involved. H.R. Rep. No. 2894, 76th Cong., 3d Sess. 13, 14, 19 (1940). The Senate Finance Committee, however, extended the provision to the computation of excess profits net income for the later years as well—the years involved in the instant case—to apply whether income was to be based on either income credit or invested capital method, thereby proposing an amended section 711(a)(2) which had it been enacted would have disallowed "the deduction otherwise allowable under section 23(a) for expenses paid or incurred in connection with such retirement or discharge (including any premium paid upon any such retirement or discharge), the deduction for losses otherwise allowable in such connection, and the deduction otherwise allowable on account of the issuance of the bonds or other evidence of indebtedness at a discount." S. Rep. No. 2114, 76th Cong., 3d Sess. 11–12 (1940). At the same time the committee was in the quoted words speaking of disallowing "expenses" and "losses," plaintiff emphasizes, the committee spoke of "interest" as the subject matter of section 711(a)(2)(B). S. Rep. No. 2114, *supra*, at 12. The conference committee report eliminated the proposed change for all years, retaining it only in section 711(b)(1)(D) for the base years. H.R. Conf. Rep. No. 3002, 76th Cong., 3d Sess. 46 (1940).

Plaintiff would see in the Senate's bill an understanding of Congress that the deductions for amortized bond discount, unamortized bond discount and call premium were expenses and losses rather than interest. In other words, that proposed change in the law was on the premise that discount and premium were not, as interest, already subject to section 711(a)(2)(B).

The contention aggrandizes an ambiguous legislative incident into the full-blown status of an intent of the whole Congress of material significance on the construction question which is presented. It may be, as plaintiff contends, that the premise and thus the understanding of the framers of the Senate bill was that call premiums and unamortized bond discount were not interest covered by section 711(a)(2)(B). It may also be that though believing that such items, as interest, were subject to section 711(a)(2)(B) and thus to halving only, the draftsmen desired to change the law and achieve a 100 percent disallowance, and thought that section 711(b)(1)(D) was a convenient vehicle because discount and the like were also expenses and losses. We do not know the premise of the Senate bill. We do know that the conference committee rejected the bill as drawn in the Senate, and so whatever was the premise of the Senate bill, it was not Congress' premise.

The conference committee's thinking is equally unknown. Its report gives only the fact of what it did.[25] We do not know if it felt that discount and call premiums were interest, already covered by 711(a)(2)(B), and should not be treated as losses and expenses under section 23, or whether it felt that such items were not interest, but should nevertheless not be disallowed in full. But whatever were the conference com-

[25] The committee said:

"(2) The adjustment requiring that certain deductions otherwise allowable on account of the retirement or discharge of bonds, etc., should be excluded from the computation has been eliminated for taxable years after the base period. As retained relative to taxable years in the base period, it has been redrafted so as to make certain that the excluded deduction on account of the issuance of bonds, etc., at a discount relates only to discount unamortized on the date of the retirement or discharge. The ordinary deduction for amortization of bond discount accrued for that portion of the taxable year preceding the retirement or discharge is not to be excluded from the computation." H.R. Conf. Rep. No. 3002, *supra*, at 46.

mittee's views, it cannot be said that it concurred in the version of the Senate's view which squares with the plaintiff's position.

The Senate's view, whatever it was, was surely not the intent of Congress in enacting or construing section 711(a)(2)(B). The understanding of existing law by one house in the course of legislation, at least in such ambiguous circumstances as are here present, cannot be given effect as the intent of Congress. Too many doubts and questions would surround the result, and as has been said, it is the function of legislative history to resolve doubts and not to create them. The indecisive evidence of legislative intent presented by plaintiff may not gainsay the abundant authority, set out above, supporting the conclusion that amortized bond discount, unamortized bond discount and call premiums paid on retirement of bonds are, all, interest under section 711(a)(2)(B).

The Government is entitled to prevail on additional defense 6.

X. DONATIONS AND CREDITS

By count 17 and related counts, plaintiff seeks to add $3,675,562.72 to its equity invested capital for the year 1942 and $9,798,364.02 and $9,891,701.23 to the equity invested capital of its subsidiaries and itself for the respective years 1940 and 1941, when it filed returns consolidated with its subsidiaries.[26] The additions would decrease plaintiff's tax by increasing its excess profits tax credit for 1942 and its unused consolidated excess profits tax credit carryover from 1940 and 1941 to 1942.[27]

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[26] Counts 17, 21 and 24 directly seek the increase in equity invested capital described in the text. Counts 19, 22 and 25 seek consistent treatment for purposes of computing total assets.

[27] To put the issue in its context, it may be said that the Excess Profits Tax Act of 1940, as amended in 1942, levied a tax of 90 percent (subject to a post-war credit of 10 percent and an overall ceiling of 80 percent on combined income and excess profits tax) on corporate "excess profits net income" remaining after an allowance of an exemption and an excess profits credit representing normal profit. Title II, Second Revenue Act of 1940, as amended, § 710 *et seq.*, 54 Stat. 974, 975, as amended, I.R.C. (1939) as amended, § 710 *et seq.*, 26 U.S.C. (1940 ed. and Supp. II). The taxpayer was given the alternative of computing the credit on the basis either of average income over a base period or (the method chosen by plaintiff) "invested capital."

These sums are the account balances, as of the close of the years in question, representing facilities which were constructed with or composed of the cash and property transferred by nonstockholders to plaintiff and its subsidiaries in literally thousands of "donations and grants" from nonshareholders during the years 1914 through 1942. No income tax was paid on the receipts. They were recorded as assets in the books of plaintiff and its subsidiaries (henceforth, together, called the plaintiff) and were held in the tax years in question for use in plaintiff's trade or business.

The Commissioner of Internal Revenue with a few exceptions disallowed the inclusion of these manifold donations and grants in plaintiff's equity invested capital. Plaintiff challenges the disallowance. In a defense of setoff, the Government challenges the Commissioner's allowance of the inclusion in equity invested capital of six donations and grants.

The parties have by agreement reduced the thousands of transfers involved to 56, to represent all the transfers, and they have also agreed, in the course of their proposals for findings, upon individual transfers to represent the several classes of transfers. These classes are as follows, the amounts stated being those for transfers made prior to January 1, 1940:

Class 1, by far the largest, accounting for $5,992,110 of the $9,798,364 involved, is *governmental transfers to relocate line on account of dams*. It is represented by transactions in which the Federal Government paid the plaintiff the cost of relocating or protecting such parts of its line as would be flooded or threatened by a rise in water level by reason of a Government dam about to be built.

The Act took a historical approach to the computation of invested capital; it would be composed of "equity invested capital" or the total money and property paid in and left in the corporation (excluding "inadmissible assets" such as stocks and bonds), a prescribed percentage of outstanding borrowed capital and accumulated earnings and profits up to the beginning of the taxable year.

Once invested capital is determined, graduated percentages are applied to determine the excess profits tax credit. The percentages in 1942 were 8 percent of the first $5 million of invested capital, 7 percent of the next $5 million, 6 percent of the next $190 million and 5 percent of amounts over $200 million.

The Act was repealed in 1945. 59 Stat. 556, 558.

Class 2, $251,669, *governmental transfers to relocate line on account of highways*, is represented by a case in which the City of Long Beach, as part of a plan to build a new highway, by agreement paid the plaintiff $240,000 for the latter's right to operate on certain streets and the right to use, for pedestrian and vehicular traffic, the plaintiff's drawbridge across a harbor entrance.

Classes 3 and 4, $1,947,206, *governmental transfers for highway underpasses and other highway construction*, are represented by transfers in which a state or city, in the interest of public convenience and safety, and in many cases using federal funds made available for the purpose, paid the cost of railroad highway crossings such as a new grade crossing or the replacement of a viaduct with a highway subway under the railroad's line. These transfers are governed by *United States* v. *Chicago, Burlington & Quincy R.R.*, 412 U.S. 401 (1973), in which substantially identical [28] transfers were held not to effect contributions to capital.

Class 5, $320,601, *governmental miscellaneous transfers*, is divisible as follows: (1) 12 percent is represented by transfers substantially identical with classes 3 and 4; (2) 87.2 percent is represented by payments for fences and street lights on land leased from the plaintiff, cables for utility lines, water mains and irrigation waterways under the right-of-way, and (3) 0.8 percent is represented by a transfer to build sanitary facilities on the plaintiff's premises.

Class 6, $891,354, *private transfers for spur and other tracks*, is represented by several transfers by shippers for the construction of spur tracks to the transferor's plant or installation and two transfers by nonshippers, one identical with those in class 1, *supra*, except that the transferor was a private power company, and the other a railroad with whom plaintiff maintained a joint installation at a highway crossing.

Class 7, $395,422, *private miscellaneous transfers*, is represented by transfers involving payments for street lights on leased property paid for by the lessees; a private road and gates across the right-of-way for the use of, and paid for by, the owner of the land on both sides; feed racks and a scale paid for by a stock yard for its use; a culvert needed and paid for by a water company; a storage facility and a power line for the use of an express company, paid for by it; and a retaining wall needed for a spur track to a shipper's plant, paid for by the shipper.

[28] It is of no consequence that it does not appear in the instant case, as it did in *Chicago, Burlington & Quincy R.R., supra*, that in all of the transfers the taxpayer railroad assumed a contractual obligation to maintain and repair the facility which was the subject of the transfer. There is every reason to expect that a railroad will in fact maintain, repair and renew the facilities which it owns, in this context typically that portion of a subway structure upon which its track rests or that portion of a grade crossing which it owns.

The issue is whether the facilities built with the cash and property transferred may properly be treated as "money" and "property" "paid in" by nonshareholders "as a contribution to capital," and thus includible in equity invested capital under the 1939 Code.[29] *See* Treasury Regulations 112 § 35.718–1 (1944).

The dispute centers first on classes 1 and 2 of the transfers in question. As noted above, classes 3 and 4 are governed by *Chicago, Burlington & Quincy R.R., supra*, and classes 5–7 are of a miscellaneous nature whose disposition will best be discussed after decision on classes 1 and 2.

In briefs filed before the decision of *Chicago, Burlington & Quincy R.R., supra*, plaintiff contended that the transfers were made to induce the construction and operation of its railroad for the service and safety of the public and were therefore contributions to capital under *Edwards* v. *Cuba R.R.*, 268 U.S. 628 (1925). *See Texas & Pacific Ry.* v. *United States*, 286 U.S. 285 (1932). *Edwards* v. *Cuba R.R., supra*, held that payments of money and property by the Govern-

[29] "§ 718. Equity invested capital—(a) Definition.

The equity invested capital * * * shall be the sum of the following amounts * * *

(1) Money paid in.

Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

(2) Property paid in.

Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. If the property was disposed of before such taxable year, such basis shall be determined in the same manner as if the property were still held at the beginning of such taxable year. If such unadjusted basis is a substituted basis it shall be adjusted, with respect to the period before the property was paid in, in the manner provided in section 113(b)(2); * * *"

ment of Cuba to a railroad corporation, conditioned on the construction of a railroad line—so much per mile—were made as reimbursement for capital expenditures rather than as a gift or to obtain rate concessions and in consequence were not profits or gains taxable as income. The distinctive feature of the transaction was that the Cuban Government was acting deliberately to induce the construction of a railroad, and to promote its success by making a grant towards its capital. The transfers were akin to those made by Congress to the first Union Pacific Railroad, in the Pacific Railway Acts in the last century. Such transfers are utterly unlike those presently in question. *Edwards* v. *Cuba R.R.* is therefore not helpful.

The remaining arguments of the parties are based on *Detroit Edison Co.* v. *Commissioner*, 319 U.S. 98 (1943) and *Brown Shoe Co.* v. *Commissioner*, 339 U.S. 583 (1950), from which the Supreme Court in *Chicago, Burlington & Quincy R.R.*, *supra*, recently distilled a number of the characteristics of a contribution to capital under the Code.[30]

A contribution to capital, the court wrote, "must become a permanent part of the transferee's working capital structure"; it "may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee." It "must be bargained for" (and thus assets granted by a governmental body for replacement of existing facilities, where none otherwise would have been deemed necessary, are not contributions to capital), and the asset transferred "foreseeably must result in benefit to the transferee in an amount commensurate with its value." Finally, "the asset ordinarily, if not always, will be employed

[30] The decision in these cases, involving primarily the issue of depreciability of assets transferred to the taxpayer, turned on whether the asset involved was a contribution to capital, for the income tax act beginning in 1932 provided that the basis of a contribution to capital should be the basis of the transferor, and thus the contribution to capital would be depreciable though having had no cost to the transferee. Section 113(a)(8) as added by the Revenue Act of 1932 c. 209, 47 Stat. 198; I.R.C. 1939, § 113(a)(8). The section confirmed the exemption from income taxation for the class of shareholder contributions, a class broadened by *Edwards* v. *Cuba R.R.*, *supra*, to include the nonshareholder contributions described in the text, *supra*. In the 1954 Code, the former result was changed by a provision for an exclusion from income for all contributions to capital of corporations, with the proviso that the basis of the contribution by a nonshareholder should be zero. §§ 118, 362(c), Int. Rev. Code of 1954.

in or contribute to the production of additional income and its value assured in that respect," and thus assets intended for the safety of the public are not contributions to capital, because they were "peripheral to the road's business" and "did not materially contribute to the production of further income by the railroad." 412 U.S. at 413–414.

As already noted, the facts of classes 3 and 4 of the transfers in the instant case are substantially identical with those in *Chicago, Burlington & Quincy R.R.*, *supra*, and thus the decision there decides that classes 3 and 4 here are not contributions to capital.

The other classes may be summarily disposed of in the light of the characteristics of a contribution to capital set out in *Chicago, Burlington & Quincy R.R.*, *supra*.

The transfers in class 1, typified by a transfer by the Federal Government to the plaintiff to replace a portion of the right-of-way to be flooded by a projected dam, were matter-of-fact business transactions in which the parties made an equal exchange, without altruism or donative intent. The closest analogy is a condemnation proceeding; no one would contend that payment of a condemnation judgment or of a sum in settlement to avoid an eminent domain proceeding is a contribution to capital. In the words of the majority opinion in *Chicago, Burlington & Quincy R.R.*, *supra*, the transfers in class 1 "simply replaced existing facilities" and "did not materially contribute to the production of further income by the railroad." 412 U.S. at 414.

In *Los Angeles & S.L. R.R.* v. *United States*, 86 Ct. Cl. 87, 21 F. Supp. 347 (1947), a railroad (actually a subsidiary of the present plaintiff) gave up a portion of its line to a mining company in need of the land for an extension of the mine's tailings dumps and received in return a new line as a replacement. This court said that the new line, though costlier than the old, "was of no more use to the railway company than the old line and would not produce a cent more income" or increase the value of the railroad's assets "by a single dollar." 86 Ct. Cl. at 99–100, 21 F. Supp. at 353.

Class 2 transfers are essentially the same as those in class 1 and are equally with class 1 not contributions to capital. Classes 3 and 4, as already noted, are not contributions to

capital on the authority of *Chicago, Burlington & Quincy R.R., supra;* 12 percent of the transfers in class 5, found to be essentially the same as the transfers on classes 3 and 4, are also not contributions to capital.

Of the remaining 88 percent of the transfers in class 5, 87.2 percent are represented by these transfers: (1) a state prison, as required by its lease of a portion of the plaintiff's right-of-way for use as a pasture, paid for a "hog-tight" fence for the prison farm; (2) a state paid its share of a municipal assessment for street lighting on the railroad's grounds at a railroad station, in accordance with the easement contract covering encroachment of the state's highway on the station grounds; (3) a municipal department of power and light paid for the cost of cables for telephone and telegraph lines, to replace open wire lines; the record gives no further details; (4) a town paid for the cost of a water main, under the right-of-way, to the municipal stockyard; (5) and (6) federal irrigation agencies paid for the cost of irrigation waterways under the plaintiff's line.

In all of these it appears that the transfers were essentially an exchange of values or a payment for a specific quid pro quo which left the plaintiff transferee no better off than before and did not materially contribute to the production of further or additional income. Accordingly, under *United States* v. *Chicago, Burlington & Quincy R.R., supra*, the transfers did not effect contributions to the capital of the plaintiff.

The final subgroup of 0.8 percent of the transfers in class 5 is represented by a transfer in 1938 in which a town in Kansas furnished $129 worth of W.P.A. labor to construct four new sanitary privies, notice having been given the railroad by the town to abate the nuisance of unsanitary privies. The scanty record leaves a net impression that in this transfer the town intended, in the interest of the users of the facilities, to confer a benefit upon the railroad, and that the transfer replaced existing facilities with new and better ones which plaintiff would otherwise have been required to construct out of its capital funds and thus that the transfer resulted in a benefit to the transferee in an amount commensurate with its value in that it enabled the plaintiff to avoid a capital expenditure to the value of the assets transferred. The sum whose expenditure was avoided was employed in the production of further or additional income. This group of transfers therefore meets the *Chicago, Burlington & Quincy R.R.* test for a contribution to capital.

The Government maintains that in any event the thing contributed was services, and neither "money" nor "property," as required by § 718 for inclusion in equity invested capital. There is authority that services compensated with stock are neither "money" nor "property" includible in invested capital. *Bard-Parker Co.* v. *Commissioner* 218 F. 2d 52 (2d Cir. 1954), *cert. denied*, 349 U.S. 906 (1955); *Western Maryland Ry.* v. *United States*, 227 F. 2d 576 (4th Cir. 1955), *cert. denied*, 351 U.S. 907 (1956). The more pointed cases, however, albeit decided under an earlier excess profits tax act, recognize that such one-time services as those of architects and engineers which go directly into the creation of a tangible capital asset are so sufficiently reflected in capital assets that their value is includible in invested capital. *Federal Plate Glass Co.* v. *Commissioner*, 6 BTA 351 (1927); *Coatesville Boiler Works* v. *Commissioner*, 9 BTA 1242 (1928); *see Palomar Laundry* v. *Commissioner*, 7 TC 1300 (1946). By the thinking of those cases, the cost of the labor used in building the privy is, as much as the lumber and roofing used, a capital asset and includible in equity invested capital. Money actually passed to workmen who labored to build a structure which became a capital asset. No case holds the cost of such labor not includible in equity invested capital. No principle or policy requires that it be not includible, for the transaction is wholly realistic, without any possibility of exaggeration or evasion. *See Union Pacific R.R.* v. *United States*, 185 Ct. Cl. 393, 401 F. 2d 778 (1968), *cert. denied*, 395 U.S. 944 (1969), *rehearing denied*, 194 Ct. Cl. 1021, *cert. denied*, 403 U.S. 931 (1971).

In the nongovernmental transfers, classes 6 and 7 described above, the transfers were substantially identical to those in class 1 and to the transfers comprising 87.2 percent of the transfers in class 5, or were direct payments for specific things or services. The transfers in those two classes, therefore, are under *Chicago, Burlington & Quincy R.R., supra*, not contributions to capital.

The transfers challenged in the plea of setoff, and the decisions thereon, are as follows:

(1) $200,000 for a spur track to a smelter about to be built, paid for in 1901 by the owner of the smelter; held a payment for a specific quantifiable service and therefore not a capital contribution under *Chicago, Burlington & Quincy R.R.*, *supra.*

(2) $1,076 for railroad line from Orchard, Idaho, to Boise, Idaho, to connect with the existing line from Boise to Nampa, to provide through train service for Boise; paid for in 1925 by the Chamber of Commerce of Boise, Idaho; held this transfer was not a payment for a thing or a service, was bargained for, resulted in benefit to the transferee in an amount commensurate with its value, and the assets transferred were employed in the production of further or additional income. It was therefore a contribution to capital under *Chicago, Burlington & Quincy R.R., supra, Brown Shoe* and *Edwards* v. *Cuba R.R., supra. See Federated Department Stores* v. *Commissioner*, 426 F. 2d 417, 420 (6th Cir. 1970).

(3) $28,338 for land for a new line from Rogerson, Idaho, to Wells, Nevada, provided in 1925 by a citizens right-of-way committee for the purpose of obtaining a more direct outlet to the California market for Southern Idaho agricultural products, and to open up for tonnage shipments numerous copper mining properties adjacent to the new line. This transfer had the same characteristics as the immediately foregoing transfer and is equally a capital contribution.

(4) $100,000 paid by a citizens committee in 1928 to acquire and transfer to plaintiff a small road which had ceased operations, in consideration of plaintiff's promise to operate it permanently. This transfer was essentially similar to the two foregoing transfers and is equally a capital contribution.

(5) $46,125 paid by the Utah Copper Company to reimburse the plaintiff for the additional expenses of operating a relocated line, in the circumstances detailed in *Los Angeles & S.L.R.R.*, v. *United States*, *supra.* This transfer is held not a capital contribution for the reasons stated above in connection with classes 1 and 2.

(6) $240,421.01 transferred by a citizens committee in 1925.

Plaintiff has conceded that defendant is entitled to prevail on this transfer.[31]

XI. EQUITY INVESTED CAPITAL

Plaintiff also seeks a refund of taxes paid on excess profits based on an alleged erroneous determination by the Commissioner of Internal Revenue [Commissioner] of its 1942 equity invested capital credit. Plaintiff contends that the Commissioner *undervalued* its equity investment and, therefore, unduly restricted its credit. In a most unusual counter-attack, defendant also asserts that the Commissioner erred in his equity investment appraisal. However, defendant claims that the Commissioner *overvalued* plaintiff's equity. It, therefore, seeks to "offset" any other refunds due plaintiff.[32] Significantly, neither party supports the Commissioner's determination.

The Excess Profits Tax Act of 1940 grants taxpayers a "credit" for equity invested capital.[33] The Act defines equity invested capital as money and property "paid in" for stock.[34] Where a corporation is organized by issuing stock for property, the property received (invested capital) is valued with reference to the fair market value of the stock issued.[35]

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[31] Thus by agreement and by our opinion, counts 17, 19, 21 and 22 are resolved along with additional defenses 19–22.

[32] The Government may "offset" refunds due plaintiff by taxes underpaid. *Lewis* v. *Reynolds*, 284 U.S. 281 (1932); *Dysart* v. *United States*, 169 Ct. Cl. 276, 283, 340 F. 2d 624, 628 (1965). If defendant can successfully assert its offset based upon excess profits tax credit overdeterminations, he may "scale down" the recovery allowed plaintiff in Parts I and V, *supra.*

[33] INT. REV. CODE OF 1939, § 712.

[34] INT. REV. CODE OF 1939, § 718 provides:

Equity Invested Capital.

(a) Definition.—The equity invested capital for any day of any taxable year * * * shall be the sum of the following amounts, * * *

(1) Money paid in.—Money previously paid in for stock, or as paid in surplus, or as a contribution to capital.

(2) Property paid in.—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (*unadjusted*) for determining loss upon sale or exchange * * *. (Emphasis added)

INT. REV. CODE OF 1939, § 113(a) defines *unadjusted basis* for property acquired. It provides: "The *basis* of property shall be the *cost* of such property." (Emphasis added)

[35] If the taxpayer's basis is cost and stock was issued for the property, then cost is the fair market value of the stock issued for such property at the time of issuance. Treas. Reg. 112, § 35.718–1, Int. Rev. Code of 1939.

In 1898 plaintiff received the assets of the old bankrupt Union Pacific Railroad [U.P.]. On January 31, 1898, plaintiff issued 610,000 shares of $100 par common stock and 750,000 shares of $100 par, four percent preferred stock. In return, it received the stock of the old U.P. and cash (hereinafter referred to as the reorganization).[36] Later in 1899, plaintiff acquired control of the Oregon Short Line Railroad [Oregon] [37] by issuing an additional 273,493 shares of $100 par common for the Oregon common and cash (hereinafter referred to as the acquisition).[38]

Our problem, finding the correct amount of U.P.'s 1942 excess profits tax credit, then resolves into a determination of the value of the U.P. stock issued in these nineteenth century transactions.

In its return for 1942, plaintiff used par values to compute the value of its stock issued for these assets ($163.3 million).[39] The Commissioner disputed this valuation and, at first, attached a value of $122.5 million to the shares. He later modified the stock values to $79.4 million, lowering plaintiff's valuation substantially. Plaintiff paid the 1942 deficiency and filed this refund suit claiming that its original return was correct. In addition to the stock issued, plaintiff also asserted that it was entitled to include the cash contributions received in the reorganization ($9.1 million) and the acquisition ($0.8 million) in its equity invested capital.[40]

Defendant claimed that the value of plaintiff's stock was less than even the Commissioner had determined and asserted an offset against other amounts recoverable by plaintiff. Defendant argued in its pleadings that the fair market value of the U.P. stock was only $57.5 million.

[36] The U.P. received one share of old U.P. common and $15 in return for one new share of U.P. common.

[37] Actually the U.P. issued the shares over a period of time and gradually acquired common stock of the Oregon. *See* page 16, infra. However, the U.P. acquired control of the Oregon in 1899.

[38] In return for each share of U.P. common stock issued in the acquisition, the U.P. received one share of Oregon common and $3 cash.

[39] Plaintiff contended that its equity invested capital was $61 million for the reorganization common, $75 million for the reorganization preferred, and approximately $27.3 million for the acquisition common—a total equity invested capital of $163.3 million.

[40] *See* notes 36 and 38, *supra*.

During the trial, plaintiff sought to prove an even greater valuation, and defendant continued to support the value that it had alleged in its pleadings. Plaintiff's valuation expert testified that the proper valuation date for the reorganization stock was January 31, 1898. However, he stated that the true value of the stock must take into account the U.P.'s rapid rise in fortunes during the post-reorganization period. Thus he evaluated the U.P. reorganization and acquisition stock by use of 1907 stock market figures and found values of $175–200 per share for the common and $100 per share for the preferred. His total value estimate was $251.7 million. Defendant's trial expert testified that after considering all valuation techniques,[41] the reorganization common was worth $22.50 per share and the reorganization preferred, $40 per share. Since he rated the acquisition common at $10 million, he assessed plaintiff's total equity invested capital at $57.5 million.

Both plaintiff and defendant contend that the Commissioner's valuation was incorrect and both ask the court to find a per share value for the stock. Significantly, there is absolutely no justification in the record for the Commissioner's valuation since neither party supported it.

The threshold question is whether either party's evidence overcomes the Commissioner's presumption of correctness.

A. *Presumption of Correctness:*

The Commissioner's determination of taxes due is entitled to a presumption of correctness. *Helvering* v. *Taylor*, 293 U.S. 507 (1935); *Northlich, Stolley, Inc.* v. *United States*, 177 Ct. Cl. 435, 442, 368 F. 2d 272 (1966). This presumption applies to excess profits tax credit determinations. *Tri-State Realty Co.* v. *Commissioner*, 180 F. 2d 593 (5th Cir. 1950). However, in our case an unusual situation is presented because neither party supported the Commissioner's determination. Each attempted to assert its own conclusion for asset valuation.

The court believes that there is sufficient evidence in the record to rebut the presumption. Presumptions are not evi-

[41] Defendant's expert testified on stock market values, net asset values, price-earnings estimates, capitalization of earnings, and comparison of the U.P. stock with similar railroad stocks.

dence, and they disappear in the face of substantive evidence tending to disprove them. *United Aniline Co.* v. *Commissioner*, 316 F. 2d 701, 704 (1st Cir. 1963); *Kentucky Trust Co.* v. *Glenn*, 217 F. 2d 462, 465 (6th Cir. 1954). Defendant provided sufficient probative evidence of the U.P. value by offering stock market prices for the U.P. stock to rebut the Commissioner's presumption of correctness.

Once we find that the presumption has been rebutted, we must then determine whether either party has met its burden of proof and, therefore, is entitled to a refund or offset.

B. *Burden of Proof:*

Where plaintiff sues for a refund he has the burden of proving that the refund is "legally due" him. *Helvering* v. *Taylor*, *supra; Lewis* v. *Reynolds*, 284 U.S. 281 (1932). Where defendant counters with an offset claim, allocation of the burden depends on the nature of the offset. If the offset is based upon the same tax return as plaintiff's refund claim, the ultimate burden of proof remains on plaintiff. However, defendant has the burden of "coming forward" with sufficient facts to show that it "has a reasonable basis for its set-off." *Missouri Pacific R.R. Co.* v. *United States*, 168 Ct. Cl. 86, 338 F. 2d 668 (1964). In the instant case, plaintiff has the ultimate burden of proving that the Commissioner undervalued its equity. Since its offset claim involves the same tax return, defendant must "come forward" with sufficient evidence to show that there is a reasonable basis for its claim that the Commissioner overvalued the U.P. stock.

Valuation of assets is a question of fact. *American Steel Foundries* v. *United States*, 153 Ct. Cl. 234 (1961). The question before the court is the value of the U.P. investment. The court may adopt plaintiff's conclusions, may adopt defendant's, or any reasonable value in between. *Toronto, Hamilton & Buffalo Nav. Co.* v. *United States*, 116 Ct. Cl. 184, 207–08, 88 F. Supp. 1016, 1022 (1950). We find from the stock market prices presented by defendant that it has met its burden of coming forward. There is sufficient evidence to find a reasonable basis for defendant's allegation of overvaluation by the Commissioner. We also find that plaintiff has failed to meet its burden of proving that the

Commissioner undervalued the investment. We hold that defendant is entitled to an offset.

C. *Equity Valuation:*

Valuation of property is at best an inexact science or highly imprecise art, and there are as many approaches to valuation as there are valuation experts. Asset appraisal, therefore, requires a reasonable or rational approximation rather than exactitude. Primary valuation techniques include actual sale prices, actual or original cost, replacement cost, capitalized income, price-earnings ratios, and comparison with similar property. I *J. Bonbright, Valuation* 113–269 (1937). Each method has its own variations, strengths and weaknesses. We have received evidence of U.P. value based upon stock market prices, net asset values, capitalization of earnings, price-earnings ratios and comparison of the U.P. with similar stock.

While each valuation method has shortcomings, we find sufficient evidence to adduce a reasonably accurate value for U.P.'s reorganization and acquisition stock.

The departure point for our valuation inquiry begins with the proposition that "fair market value is the price at which property would change hands in a transaction between a willing buyer and a willing seller, neither being under a compulsion to buy or sell, and both being reasonably informed as to all relevant facts." *Bankers Trust Co.* v. *United States*, 207 Ct. Cl. ——, ——, 518 F. 2d 1210, 1219 (1975); *Jack Daniel Distillery* v. *United States*, 180 Ct. Cl. 308, 315–16, 379 F. 2d 569, 574 (1967). This court has frequently used stock market prices to value stock. As Judge Davis noted in *Bankers Trust*, "Where stock is freely traded in an open, organized market, stock exchange quotations for the valuation date generally provide the best evidence of value." *Bankers Trust Co., supra*, slip opinion at 13 citing *Moore-McCormack Lines, Inc.* v. *Commissioner*, 44 T.C. 745, 759 (1965); *Southern Natural Gas Co.* v. *United States*, 188 Ct. Cl. 302, 351–52, 412 F. 2d 1222, 1252 (1969); 10 *J. Mertens, The Law of Federal Income Taxation* §§ 59.13 at 42–43, 59.14 at 47 (1970). The *Bankers Trust* opinion contains an excellent analysis of the situations in which stock market

values are not accurate value determinants.[42] We note that such situations are not present in the instant valuation.[43]

Two factors which give us pause in considering stock market values are the "pessimistic" nature of the market in 1898–99, and the likelihood of reacquisition of the Oregon stock at the time of reorganization. While these factors might possibly cause some doubt as to the reliability of market evaluation, we find that, in the instant case, they do not. The pessimism of investors in the then current economic situation was well-founded. The nation had undergone a severe depression, and recovery was not a foregone conclusion. In addition, the U.P. itself had recently undergone bankruptcy and was in the process of reorganization. Its total mileage had shrunk, and it had no West Coast outlet. The only factors which gave the U.P. any value at all were the possibility of economic recovery and reacquisition of branch lines lost during bankruptcy. We conclude that rather than being of doubtful worth in estimating the value of the U.P. stock, the market serves as its most accurate indicator.[44] In short, the stock exchange values produce the most accurate and comprehensive analysis of the U.P. stock possible after a lapse of some 77 years.

Having determined that we will employ stock market values, we must then decide the dates we will use to appraise the stock. The Excess Profits Tax Regulations mandate val-

[42] (1) If the market is too thin to absorb the shares offered for sale; (2) if too few sales are made to place any reliance on the validity of the prices commanded; (3) if restricted stock is sold; (4) if an agreement not to resell exists; (5) if so many shares are sold that supply exceeds demand and a "blockage discount" must be accounted for, or finally, (6) if the stock prices increase as a result of the agreement to sell, then the market valuation of the stock may be inadequate. *Bankers Trust, supra,* slip opinion at 14–20.

[43] In all instances, there were sufficient sales to indicate the reliability of the market price determinations, yet not so many sales as to indicate the usefulness of determining any "blockage" factors.

While the reorganization and acquisition agreements themselves may have added some value to the U.P. stock, (a main concern of Judge Kashiwa's dissent in *Bankers Trust*) it does not appear to be significant here.

[44] Stock exchange quotations automatically take some cognizance of many valuation factors. For example, good will; the nature of the business and history of the enterprise; the economic outlook in general and that of the specific industry in particular; estimate of dividend paying capacity; and sales of similar stocks. Most importantly, the stock market provides a "black and white" unbiased and contemporaneous measure of the value of the U.P. stock.

uation at the time of issue.[45] Clearly market quotations are more reliable if they are near in time to the event in question. 10 *J. Merten, Law of Federal Income Taxation,* § 59.16 (1970). In the instant case, the reorganization stock was issued on January 31, 1898. Reorganization preferred first traded on February 2, 1898. Since this date is fairly contemporaneous with the organization, February 2, 1898 becomes the logical date upon which to rate the reorganization preferred. We therefore adopt February 2, 1898. The reorganization common was not traded until February 25, 1898. This is somewhat remote. However, we can derive market values for the reorganization common on February 2, 1898 from the price of U.P. Trust Receipts.[46] Thus we again use the February 2, 1898 valuation date to assess the reorganization common.

Determining valuation dates for the acquisition common presents another problem. The U.P. issued this stock in several blocks over a period of ten years.[47] Here we use average market prices during the time period that the U.P. issued each block of shares.

After establishing valuation dates, we must next settle upon a technique to determine the specific market price on the date in question. Although found in the Estate Tax Regulations, a generally accepted procedure in income tax cases is to use the average between high and low prices on the date in question.[48] We accept this method. The average between high and low market values on February 2, 1898 represents the most accurate value for the reorganization stock. The average between high and low for each date during the several time periods in which the U.P. issued its acquisition stock is again the most accurate value for the acquisition stock.

Our first measurement concerns the value of the 750,000 shares of U.P. preferred issued during the reorganization. The *reorganization preferred* was first traded on February 2,

[45] Treas. Reg. 112, § 35.718–1, *supra* note 35, calls for valuation of the U.P. stock "at the time of issuance."

[46] *See* page 15 *infra.*

[47] *See* chart page 16 *infra.*

[48] Treas. Reg. § 20.2031–2(b). *Bankers Trust, supra,* slip opinion at page 13.

1898. *The average between high and low for the preferred on this date was $62.50.* Thus the court finds that the 750,000 shares of U.P. preferred issued in the reorganization were worth $46.9 million. Note that 122,644 shares of U.P. preferred were traded during the first week of issue, an average of 24,549 per day. Although this is a fairly large block of stock, it is nowhere near the entire amount. Thus there were sufficient shares of U.P. preferred traded at the time of issue to support the validity of the price set by the market, yet not so many shares that the market failed to absorb them.

Evaluation of the *reorganization common* presents another problem. The first shares of U.P. common were not traded until nearly a month after the reorganization, February 25, 1898. However, U.P. Trust Receipts, exchangeable for one share of U.P. common and 15/100 of a share of preferred were traded on the market at the time of the reorganization. Using February 2, 1898 Trust Receipt values (an average of $36 per share), less 15/100 of the $62.50 value found for the preferred ($9.375), *we derived a value of $26.625 for the U.P. common on February 2, 1898.* Thus 610,000 shares of new U.P. common were worth $16.2 million. Again we note that approximately 35,321 Trust Receipts per day were traded during the week in question. Again this is sufficient number of shares to find that the market set an accurate trading price.

The U.P. issued the acquisition stock in blocks over a ten-year period. Defendant has presented evidence which permits the court to separate this stock into several blocks and identify an average market price for each block. We adopt this evidence and find the following values for the U.P. acquisition stock.

From	To	Number of Shares	Market Average	Total Value
1-26-99	2-25-99	137, 301	$46. 00	$6, 315, 846
2-26-99	3- 4-99	68, 650	47. 00	3, 226, 660
3- 5-99	3-11-99	27, 460	47. 00	1, 290, 620
3-12-99	6-30-99	31, 642	44. 00	1, 392, 248
7- 1-99	12- 1-99	1, 966	46. 00	90, 436
12- 2-99	6-30-00	3, 688	50. 50	186, 244
7- 1-00	6-30-01	2, 636	91. 50	241, 194
7- 1-01	6-30-02	50	175. 00	8, 750
7- 1-07	6-30-08	100	175. 00	17, 500
		273, 493	----------	$12, 769, 188

Thus the court finds that the investment in the Oregon, the *acquisition common*, was worth $12.8 million.

The reorganization common, the reorganization preferred, and the acquisition common yield total U.P. equity invested capital of $75.9 million. The court believes that this value is neither too pessimistic [49] nor too optimistic.[50] In each case, there are sufficient market sales to bolster the validity of the price placed upon the shares in the marketplace, yet not so many shares traded that the market found itself unable to absorb them.

In addition, we note that other evidence of value in the record supports our determination. First, although unsupported, the Commissioner's value of $79.4 million is close to that found by the court. Second, by using the net asset values placed in the record by defendant, $116.9–$119.9 million, plus a 15 percent estimate for going concern value and goodwill (factors ignored by defendant in its testimony on net asset values), less debt issued by U.P. during reorganization ($81.7 million in bonds then selling at 92 or $75.2 million in debt securities), we derive a value for the U.P. reorganization assets of $59.2–$62.7 million. Adding the value of the Oregon assets obtained in the acquisition, $12.8 million, we derive a reasonable estimate of total equity based upon net assets and goodwill less debt of $72.0 million to $75.5 million. The stock market values found by the court are nearer the $75.5 million figure. Our stock market figures for the reorganization stock appear to be well-founded.

Finally, viewing the acquisition stock alone, various facts in the record again bolster our determination of value. For example, by using an 1899 average of the price-earnings (P/E) ratios of three comparable railroads [51] (9.8), we find that of the $5.12 per share U.P. earnings in 1899, some $1.4

[49] The court believes such valuation is not unduly pessimistic. Notably, the value of the U.P. common and preferred actually fell during 1898 before climbing again.

[50] Defendant's expert would have the court find that the market overvalued the U.P. stock. Since other valuation estimates tend to bolster our finding, we believe that market prices were not unduly optimistic. Certainly by 1899 the market value of the U.P. stock had risen dramatically.

[51] The Southern Pacific [SP], the Northern Pacific [NP] and the Chicago and Northwestern [CNW], three railroads which defendant's expert excluded from his category of "established dividend payers" and, therefore, similar to the U.P. The 1899 P/E ratio for the SP was 8.5, the NP, 8.4 and the CNW, 12.6. Thus the average P/E ratio for these three railroads in 1899 was 9.8.

million in earnings were attributable to the acquisition common. (273,493 shares x $5.12 per share.) Multiplying the P/E ratio for the similar stocks by the earnings attributable to the U.P. acquisition common, we find a reasonable estimate for the Oregon of $13.7 million.[52] Certainly the stock market values ($12.8 million) for the acquisition common are conservative estimates of their value.

Thus the value determined by the Commissioner, the value based upon net assets, and price-earnings ratios lend support to our valuation.

In short, using stock market prices to value the equity invested capital of the U.P. for 1942 excess profits tax purposes, the court finds that the Commissioner overvalued the U.P. stock by some $3.5 million. Accordingly, defendant is entitled to a tax offset for the excess equity invested capital credit granted to plaintiff in 1942 based upon this figure.

Plaintiff's other contention is that it is entitled to include cash contributions received in its equity invested capital *in addition* to the value of the stock issued. The court rejects this assertion. Since new U.P. stock was issued in exchange for old U.P. common, the Oregon common, *and cash*, a proper measurement of the equity can be achieved by viewing either side of the equation; the value of the U.P. stock issued *or* the value of the stock and cash received. To allow plaintiff to include both the stock issued *and* the cash received in its equity invested capital is to "add both sides of the bargain." Certainly the cash received by the U.P. was a partial payment for the stock issued. We, therefore, hold that plaintiff cannot include the cash payments received since we value its equity with reference to the value of the stock issued.

In summary, the court finds that there is sufficient probative evidence to establish reasonable per share values for the U.P. stock issued in the reorganization and acquisition. We find that defendant has overcome the Commissioner's presumption of correctness. The court further finds that defendant has met its burden of establishing that the Commissioner overvalued the U.P. stock. We value the stock as near its issue

[52] *See American Steel Foundries, supra*, 153 Ct. Cl. at 252 for use of this valuation technique.

date as possible. The reorganization preferred was worth $62.50 per share, the reorganization common $26.625 per share, and the acquisition common ranged from $44 per share to $175 per share depending upon the date of issue. The total value of the stock issued, plaintiff's equity invested capital for 1942 excess profits tax credit purposes, was $75.9 million.[53]

To recapitulate, we find that plaintiff is entitled to recover on its refund claim based upon its right to "expense" minimum rule property in its 1942 return (Part I). Plaintiff may also recover on its contention that it would include stock of certain leased line subsidiaries in its capital assets (Part V). Finally, with regard to "donations and grants" given to plaintiff to spur its construction, we conclude that some of these grants were includable capital assets and some were not. Therefore, we hold in part for plaintiff on this assertion (Part X).

We further determine that plaintiff is not entitled to recover refunds for other allegations since it cannot deduct 1943 payroll taxes in 1942 (Part II); it cannot include certain stock subscription rights in its earnings and profits (Part IV); and cannot receive interest on a 1948 agreement with the Commissioner of Internal Revenue (Part VI). Plaintiff also may not recover an offset to setoffs claimed by defendant because it cannot include proceeds from certain land sales in its earnings and profits (Part VII).

Defendant is entitled to prevail on its "additional defense" that plaintiff erroneously included unamortized bond discount and expense in its total assets (Part VIII). Further, we find for defendant on another "additional defense" that plaintiff mistakenly failed to treat other bond discounts and expenses as "interest" (Part IX). We also hold that defendant is entitled to recover an offset based upon its claim that the Commissioner overvalued plaintiff's equity invested capital (Part XI).

Finally, the court severs and remands for further consideration by the trial judge the question of whether plaintiff is entitled to increase its earnings and profits by $13 million due

[53] We hold for defendant on additional defense 1. Plaintiff cannot prevail on its counts 5, 6 and 9.

to certain accounting errors alleged to have occurred in 1900–1907 (Part III).

Accordingly, we find for plaintiff in Parts I, V and in some sections of Part X. We deny plaintiff's claims in Parts II, IV, VI and VII. We further hold for defendant in Parts VIII, IX and XI. The amount of the recoveries will be determined pursuant to Rule 131(c). Finally, we remand Part III for further proceedings consistent with this opinion.

NICHOLS, *Judge*, concurring in part and dissenting in part:

I concur and join in the court's opinion except for Part V, headed *Leased Line Subsidiaries*. As to this, I dissent with all respect.

The court here adopts without change the opinion recommended by Trial Judge Schwartz. While the latter, with his usual keenness of analysis, recognizes fully the difficulties of his position, he ends up applying this court's "source of supply" line of decisions which extend the *Corn Products* v. *Commissioner*, 350 U.S. 46 (1955) doctrine to cases in which a corporation invests in stock of another corporation to obtain a source of supply. *Waterman, Largen & Co.* v. *United States*, 189 Ct. Cl. 364, 419 F. 2d 845 (1969), *cert. denied*, 400 U.S. 869 (1970), and cases there cited. However, in a strangely forgotten decision, *Dearborn Co.* v. *United States*, 195 Ct. Cl. 219, 444 F. 2d 1145 (1971) a unanimous court laid down certain lines beyond which *Corn Products* and *Waterman, Largen* would not be applied, and instead the normal rule would obtain, that the purchase of corporate stock, except by a dealer in securities is a capital transaction.

Admitting that case was close, former Trial Judge Davis distinguished it because he found the purchasing corporation was motivated by substantial investment purpose and intent, besides the business purpose of assuring a source of supply. The main factors supporting this conclusion were (a) the purchaser did not pay a premium over the market value of the stock, or in other words, the purchase, if an investment, was not an unattractive one at the price paid, (b) the acquisition was meant to be permanent, not to be unloaded at the end of some temporary emergency, and (c) the purchaser intended to benefit by receipt of dividends and

by exacting a management fee to run the business, not just to integrate the subsidiary's operations into its own and make it a mere feeder of materials.

I do not find that Trial Judge Schwartz applied the same tests. As I read him, the decisive factor here is that the Union Pacific and the leased lines, run as a unified operation, could have been and no doubt were more profitable than the same lines controlled and operated separately. Without them, the Union Pacific as previously known was truncated and incomplete. To be sure! But if this is all, what we are coming to is a rule that it is not a capital investment whenever one corporation purchases control of another with the purpose, alone or among others, of integrating their operations. The kind of inquiry Trial Judge Davis made will be foreclosed because it will be irrelevant whether the purchase is attractive, viewed as an investment, whether it was intended to be permanent, constituting a permanent addition to the purchaser's fixed assets, and whether the purchaser will or will not derive the benefits a prudent investor in an unrelated enterprise would seek.

It is obvious here that the acquisition of the Oregon Short Line and the others were intended to be permanent, and have been so up to now. The Oregon Short Line and the others were themselves investors in railroad securities, and as to their investments it would appear the Union Pacific got an investment benefit. As to the other criteria, I do not find answers in the findings. I do not think the plaintiff has sustained its burden of proof.

In penning the above few words, I have assumed, as I must, the entire soundness of *Waterman, Largen* and our other decisions as well as, of course, *Dearborn*, despite previous qualms. This court's application of *Corn Products* in its "source of supply" cases can roll on down the track without any challenge by me, unless derailment by the Supreme Court or by Congress occurs. This is an area of law where *stare decisis* must prevail in this court. It is beyond our proper power now to make it easy or simple to determine whether a transaction is a capital one for tax purposes, or to do it on the basis of objective facts and statutory language, without inquiry or speculation into the undisclosed state of

mind of corporate officers, possibly ones, as here, long since deceased, and I do not so urge. My argument is directed simply against extending *Waterman, Largen* uncritically to new situations not covered by it as a precedent, and to failure to apply standards as we applied them in *Dearborn.*

I agree that the decision in *United States* v. *Mississippi Chemical Corp.*, 405 U.S. 298 (1972) does not overrule *Waterman, Largen.* It holds that a borrower from a Bank for Cooperatives, obliged to purchase a stated quantity of bank stock in lieu of a higher rate of interest, nevertheless makes a capital investment in the stock. The situation is far removed from that in our "source of supply" cases. The *Corn Products* doctrine is not mentioned. It may perhaps afford a slight clue that the Supreme Court is not so enamored of expanding *Corn Products* as we are.

Findings of Fact

JURISDICTIONAL AND GENERAL

1. Plaintiff was at all times pertinent hereto a corporation organized and existing under the laws of the State of Utah, with its office and principal place of business at 120 Broadway, New York, New York 10005.

2. Jurisdiction to hear and determine this cause is conferred upon the court by section 7422(a) of the Internal Revenue Code of 1954. Jurisdiction of the subject matter is conferred upon the court by section 1491, Title 28, United States Code.

3. Plaintiff seeks a judgment for (1) $13,409,961.46 (consisting of $9,222,801.78 in statutory interest for 1942 and $4,187,159.68 in income and excess profits tax) and assessed interest thereon paid for 1942 or such other amount as may be legally refundable for 1942, together with statutory interest thereon.

4. For federal tax purposes, plaintiff kept its books and reported its income on the accrual and calendar year basis.

5. On or about March 15, 1943, plaintiff filed a timely tentative corporation income and declared value excess profits tax return (Form 1120) and a timely tentative corporation excess profits tax return (Form 1121). On or about June 15, 1943, pursuant to a granted extension, plaintiff timely filed its final corporation income and declared value excess profits tax return (Form 1120) and final corporation excess profits tax return for the calendar year 1942 (Form 1121). Payments of the tax shown to be due thereon and two additional payments were made on or about the following dates:

Date of payment	Type of tax	Amount paid	
		Amount of tax	Amount of interest
Mar. 15, 1943	Income and declared value excess profits	$10,018,216.50	
June 15, 1943	do	9,221,074.86	
Sept. 15, 1943	do	9,619,645.68	
Dec. 15, 1943	do	9,619,645.68	
Dec. 1, 1944	Excess profits	3,525,000.00	$361,745.90
July 16, 1946	Income	10,696.86	2,141.13

6. On or about October 4, 1946, plaintiff timely filed a claim for refund of income and excess profits taxes in the amount of $1,807,514.54, or such larger amount as might be legally refundable, together with statutory interest thereon for the tax year 1942. On or about April 25, 1949, plaintiff timely filed a claim for refund of income and excess profits taxes in the amount of $7,394,419.35 plus assessed interest in the amount of $361,745.90, a total of $7,756,165.25 or such larger amount as might be legally refundable, together with statutory interest thereon for the tax year 1942. On or about April 10, 1951, plaintiff timely filed a claim for refund of income and excess profits taxes in the amount of $390,828.41 or such larger amount as might be legally refundable, together with statutory interest thereon for the tax year 1942. On or about September 11, 1953, plaintiff timely filed a claim for refund of income and excess profits taxes in the amount of $348,705.41, or such larger amount as might be legally refundable, together with statutory interest thereon for the tax year 1942.

7. On July 16, 1946, $12,837.99 in declared value excess profits tax for 1942 was credited against plaintiff's income tax liability for 1942; $196.82 in declared value excess profits tax for 1942 was credited against the tax liability of the St. Joseph & Grand Island Railway Company for 1942; $45,685.38 in declared value excess profits tax for 1942 was refunded to plaintiff with interest of $9,178.87; and $694,-

754.62 in excess profits tax for 1942 was refunded to plaintiff with interest of $68,742.63.

8. On September 16, 1960, after the audit of plaintiff's tax returns for 1942 was finally completed, a total of $7,793,-219.55 was refunded or paid to plaintiff, consisting of $3,729,-059.29 in income tax for 1942, $2,141.13 in assessed interest thereon, $13,462.80 in declared value excess profits tax for 1942, and $4,048,556.33 in statutory interest. On September 16, 1960, there was assessed against plaintiff a deficiency in excess profits tax for 1942 of $4,654,621.45 plus interest of $300,639.16, which was satisfied by a credit of $4,206,773.93 in income tax for 1942 and a post-war credit of $748,486.68.

9. Pursuant to Form 872, "Consent Fixing Period of Limitation Upon Assessment of Income and Profits Tax," timely executed on behalf of the plaintiff and the Commissioner of Internal Revenue, the period for assessment of income and excess profits taxes for the tax year 1942 did not expire prior to June 30, 1961.

10. On December 28, 1961, plaintiff filed a timely claim for refund for 1942 in the amount of $13,409,961.46 or such further amount as may be refundable, together with statutory interest thereon. Of the $13,409,961.46 claimed, $9,222,-801.78 was for statutory interest on amounts previously refunded or credited and the balance of $4,187,159.68 was for income and excess profits tax.

11. Statutory notices of disallowance were mailed to plaintiff on September 26, 1960, with respect to the claims filed on April 26, 1949, and April 10, 1951, and on August 13, 1962, with respect to the claim filed on December 28, 1961. No such notice has been issued with respect to the claim filed on October 4, 1946. Since less than 2 years elapsed between the mailing of the notices of disallowance and the filing of this suit, this action is timely brought.

12. No action or suit has been commenced or is pending in any other court on account of these claims, and plaintiff is the owner of the claims herein stated.

13. After consideration of all refunds and credits, plaintiff has paid for 1942 $30,481,263.37 in income tax and $7,184,-866.83 in excess profits tax. Plaintiff seeks to recover some portion of these payments as well as statutory interest.

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Intentionally Omitted

IX. DISCOUNT AND PREMIUMS

127. For 1940 and 1941, plaintiff and its railroad subsidiaries, including the Oregon Short Line Railroad Company and the Oregon-Washington Railroad & Navigation Company, filed consolidated income tax returns and consolidated excess profits tax returns. For 1942, plaintiff filed a separate income tax return and a separate excess profits tax return.

128. In computing net income, plaintiff deducted, on its consolidated income tax returns for 1940 and 1941 and its separate income tax return for 1942, the following amounts for amortization of bond discount and expense, unamortized bond discount and expense for bonds reacquired, United States documentary stamp taxes, and call premiums to retire bonds:

Company	Annual amortization of bond discount	Unamortized discount—bonds reacquired	Documentary stamp taxes	Call premiums	Total	Year
UP	$60,939.68	$3,265,037.46	$81,602.00	$6,442,381.12	$9,849,960.26	1940
OSL	61,316.34				61,316.34	1940
O-WR&N	111,096.46				111,096.46	1940
UP	69,411.06		28,402.00		97,813.06	1941
OSL	61,316.34				61,316.34	1941
O-WR&N	111,096.46				111,096.46	1941
UP	71,097.36				71,097.36	1942
Totals	546,273.70	3,265,037.46	110,004.00	6,442,381.12	10,363,696.28	

129. On September 1, 1940, plaintiff called for redemption two series of bonds, both with a maturity date of June 1, 2008. The first consisted of 4 percent bonds issued in the years 1908, 1909, and 1910, at a discount and with issuance expense. To redeem these 4 percent bonds, plaintiff paid the face amount of these bonds plus a premium of $4,942,381.12. The second series consisted of 5 percent bonds issued in 1923 at a discount. To redeem these 5 percent bonds, plaintiff paid the face amount plus a premium of $1,500,000. The total of the call premiums, $4,942,381.12 and $1,500,000, $6,442,381.12 is shown in the preceding finding. At the time these bonds were redeemed, there was unamortized bond discount and expense of $2,741,201.39 on the 4 percent bonds and unamortized bond discount of $517,997.28 on the 5 percent bonds. The total of these two amounts of unamortized bond discount is $3,259,198.67.

130. In May 1936, plaintiff issued 35-year 3½ percent debenture bonds at a discount. In October 1936, plaintiff issued 34-year 3½ percent debenture bonds at a discount. In 1940, plaintiff purchased certain of these debenture bonds at par with moneys derived from a sinking fund and retired them. With respect to these bonds purchased and retired, there was unamortized debt discount of $3,489.59 as to the 35-year bonds and $2,349.20 as to the 34-year bonds. The total of these two amounts of unamortized bond discount, $5,838.79, when added to the total unamortized bond discount in the preceding finding, $3,259,198.67, comes to $3,265,037.46, the figure shown in finding 129.

131. On its excess profits tax return for 1942, in computing its excess profits net income for 1942 and its unused excess profits tax credit carryovers from 1940 and 1941, plaintiff did not treat as interest the amounts shown in finding 128, but it treated the indebtedness with respect to these amounts incurred as borrowed capital.

132. On audit of the returns for the years 1940 and 1941, the Commissioner of Internal Revenue did not disturb the action taken by plaintiff as described in these findings.

133. The $110,004 in finding 128 was deducted in full in the years the bonds were issued and was not amortized over the life of the bonds as bond issuance expense. Defendant does not contend that these deductions were for interest for purposes of section 711(a)(2)(B).

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Intentionally Omitted

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XI. EQUITY INVESTED CAPITAL

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1. *Definition of the Issue*

174. The plaintiff's predecessor, The Union Pacific Railroad Company, sometimes herein called the predecessor, was incorporated on July 1, 1862, by the Act of July 1, 1862,

c. 120, 12 Stat. 489. In 1880, when it was consolidated with the Kansas Pacific and Denver Pacific, its name was changed to The Union Pacific Railway Company. The Company was in receivership between 1893 and January 31, 1898, and was succeeded by the plaintiff, as will appear. Both plaintiff and its predecessor are for convenience herein often called the "U.P."

175. Plaintiff, the Union Pacific Railroad Company, was incorporated July 1, 1897, under the general laws of the State of Utah, for the principal purpose of acquiring the property, rights and franchises of The Union Pacific Railway Company. In addition, plaintiff had the power to acquire the lands and land grants, and all rights with respect thereto, of The Union Pacific Railway Company or of its constituent companies, and to construct, purchase or otherwise acquire and operate branches, extensions and connecting or auxiliary lines.

176. As more fully set forth hereinafter, plaintiff acquired the property, rights and franchises of The Union Pacific Railway Company and certain of its constituent companies, including certain branch, extending, connecting and auxiliary lines.

177. Upon the conclusion of the receivership of its predecessor and pursuant to the reorganization plan, the plaintiff issued to the predecessor's reorganization committee, for money and property of the predecessor acquired by the committee, $90 million in 4 percent first mortgage bonds, 610,000 shares of common stock, par value $100, with an aggregate par value of $61 million, and 750,000 shares of preferred stock, par value $100, with an aggregate par value of $75 million, for distribution to the predecessor's stockholders and other claimants. The stock so issued—both the common and the preferred shares—is herein called the reorganization stock, and is the first of two blocks of stock whose valuation is the subject of the instant case.

178. During the fiscal year ended June 30, 1915, plaintiff cancelled 136 shares of its common stock, with a par value of $13,600, and 258 shares of its preferred stock, with a par value of $25,800, reducing the reorganization stock outstanding as of June 30, 1915, to 609,864 shares of common with a

par value of $60,986,400 (609,864 shares at $100 par) and 749,742 shares of preferred with a par value of $74,974,200 (749,742 shares at $100 par).

179. Pursuant to an offer made by plaintiff, following the reorganization, to issue one share of its common stock, par value $100 per share, for one share of the common stock of the Oregon Short Line Railroad Company plus $3, plaintiff issued its common stock as follows:

Period of time:	*Number of shares of plaintiff's common stock issued*
January 26, 1899 to February 25, 1899	137,301
February 26, 1899 to March 4, 1899	68,650
March 5, 1899 to March 11, 1899	27,460
March 12, 1899 to June 30, 1899	31,642
July 1, 1899 to December 1, 1899	1,966
December 2, 1899 to June 30, 1900	3,688
July 1, 1900 to June 30, 1901	2,636
July 1, 1901 to June 30, 1902	50
July 1, 1907 to June 30, 1908	100
Total	273,493

The foregoing 273,493 shares will, either intact or minus 150 shares whose value has been agreed, herein be called the post-reorganization stock, and is the second of the two blocks involved in this case.

180. By other means, plaintiff acquired prior to June 30, 1908, an additional 14 shares of Oregon Short Line common. As of June 30, 1908, no shares of Oregon Short Line common were in the hands of the public; plaintiff owned the entire amount outstanding, having a par value of $27,350,700, and the Oregon Short Line owned $109,400 par value of its common stock.

181. On its excess profits tax return for 1942, plaintiff stated the money paid in for stock, or as paid-in surplus, or as a contribution to capital to be $321,834,100, or the par value of $100 per share for the 3,218,341 shares of common and preferred stock outstanding during 1942, of which 1,633,099 shares of common and preferred were originally issued in connection with the reorganization of the Union Pacific and the acquisition of the Oregon Short Line Railroad Company.

These 1,633,099 shares were comprised of the remaining outstanding reorganization stock, that is, (1) 609,864 of the

610,000 shares of common and 749,742 of the 750,000 shares of preferred which had been issued as above-mentioned, pursuant to the reorganization plan, and (2) the 273,493 shares of common issued as above-mentioned between 1899 and 1908 to acquire the common shares of the Oregon Short Line Railroad Company.

In other words, plaintiff took the position in its tax return that the fair market value, when issued, of the then remaining outstanding shares of reorganization and acquisition stock, and thus that the fair market value, when issued, of each of the shares comprising the reorganization stock and the acquisition stock was its par value, $100 per share, with a total value of $163,349,300 for the originally issued 1,633,493 shares of reorganization and acquisition stock or a total value of $163,309,900 for the 1,633,099 remaining outstanding shares of reorganization stock and the acquisition stock.

182. Upon audit the Commissioner of Internal Revenue, determining the fair market value for the shares to be less than the plaintiff's valuation, reduced the item of money and property paid in for stock by $83,790,860 or from $321,834,100 as claimed by plaintiff on its excess profits tax return to $238,043,240. Said decrease was determined by the Commissioner to be attributable to the fair market value of plaintiff's preferred and common stock issued incident to the reorganization and to the acquisition of the Oregon Short Line Railroad Company common stock, that is, the reorganization and post-reorganization stock. The decrease was thus a decrease to $79,519,040 from the $163,309,900 at which plaintiff had valued 1,633,099 shares still outstanding reorganization and the post-reorganization stock.

The Commissioner determined that the aggregate fair market value of the reorganization stock was $67,029,150 and that the aggregate fair market value of the post-reorganization stock was $12,489,890.

It does not appear, and it is not material for purposes of comparisons, whether the Commissioner deemed the proper number of shares to be valued 1,633,493 or 1,633,099 and thus whether he valued the number of the reorganization and post-reorganization shares originally issued or as reduced by the cancellation of 394 shares (136 common and 258 preferred).

It will henceforth be assumed for purposes of comparisons that the Commissioner valued 1,633,493 shares. In any event the Commissioner determined the fair market value of stock valued by plaintiff at $163.3 million, to be $79.5 million, or less than 50 percent of plaintiff's valuation.

183. The issue is the valuation of the reorganization and acquisition stock for purposes of computation of plaintiff's excess profits tax credit for 1940 through 1942 based upon invested capital. The standard for determination of value is, as determined in the conclusions of law, the fair market value at the time of the issuance of the stock.

"Fair market value" is henceforth sometimes abbreviated to "value"; "value" when hereinafter used refers to "fair market value," unless a different meaning appears from the context.

184. Solely for purposes of the issue of valuation, it is agreed that the 150 shares of acquisition common issued after June 30, 1901, for Oregon Short Line common stock had a fair market value when issued of $175 per share.

185. The 610,000 shares of reorganization common, the 750,000 shares of reorganization preferred and the 273,493 shares of acquisition common, a total of 1,633,493 shares, are the shares issued for the money and property paid in, and those shares are thus the shares whose valuation determines money and property paid in, without regard to any cancellation of such stock thereafter.

Accordingly, while these findings will address themselves to per share values, the blocks of stock to be considered and aggregated will be the blocks originally issued, without regard to the cancellation of 394 shares after the original issuance.

186. Plaintiff contends that the value of the reorganization and acquisition common was $175–200 per share and the value of the reorganization preferred was par or $100 per share.

These values ($200 for the common and $100 for the preferred), when applied to the total of 1,633,493 originally issued reorganization and acquisition shares give an aggregate total valuation of $251,698,600.

Plaintiff thus now puts a value of $251.7 million on the stock it valued in its return at $163.3 million.

187. The Government has in an additional defense alleged that the Commissioner had only partly eliminated the overstatement in money and property paid in for stock; and that the fair market value of the reorganization stock was $47,450,000 and the value of the acquisition stock was $10,000,000 or less, a total of $57,450,000.

More specifically, on the trial, the Government has contended that the value of the 610,000 shares of reorganization common was $22.50 per share or an aggregate of $13,725,000; that the value of the 750,000 shares of reorganization preferred was $45 per share or an aggregate of $33,750,000; and that the value of the 273,343 shares (all but the last-issued 150) of the 273,493 acquisition shares issued at various times between 1899 and 1901 ranged from $35 to $112 or an aggregate of $10,046,021.50, bringing the aggregate value contended for by the Government to $57,521,021.50.

The Government thus now puts a value of $57,521,021.50 on the stock which the Commissioner of Internal Revenue valued at $79,519,040. The former figure is 72.3 percent of the latter; the latter is 138.2 (more precisely 138.24344) percent of the former.

188. The various valuations are

$251.7 million—plaintiff's valuation contended for on trial

$163.3 million—plaintiff's valuation in its return

$79.5 million—The Commissioner's valuation

$57.5 million—the Government's valuation contended for on trial

189. A comparison of the per share valuations contended for by the Government with the per share valuations derived from the Commissioner's valuation is as follows. The pro forma per share valuations by the Commissioner are obtained by multiplying the Government's per share valuations of the reorganization stock by 141.19 percent, and the Government's per share valuations of the post-reorganization stock by 124.33 percent, these being the percentages by which the Commissioner's aggregate valuations, respectively, exceed the Government's aggregate valuations.

Shares	Valuation contended for by the Government		Derived valuations by the Commissioner of Internal Revenue	
	Per share	Aggregate	Per share	Aggregate
Reorganization Stock:				
610,000 common	$22.50	$13,725,000.00	$31.76	$19,373,600.00
750,000 preferred	45.00	33,750,000.00	63.54	47,655,000.00
Total		47,475,000.00		[1] 67,028,600.00
Post-Reorganization Stock:				
137,301 common	35.00	4,805,535.00	43.51	5,974,515.71
68,650 common	35.25	2,419,912.50	43.82	3,008,586.25
27,460 common	35.375	971,397.50	43.98	1,207,718.26
31,642 common	38.00	1,202,396.00	47.24	1,494,894.64
1,966 common	43.75	86,012.50	54.39	106,936.63
3,688 common	72.00	265,536.00	89.51	330,131.32
2,636 common	112.00	295,232.00	139.24	367,052.45
Total		10,046,021.50		[2] 12,489,835.26
Total all stock		57,521,021.50		[3] 79,518,435.00

[1] The actual valuation by the Commissioner of Internal Revenue was $67,029,150.00
[2] The actual valuation by the Commissioner of Internal Revenue was $12,489,890.00
[3] The actual valuation by the Commissioner of Internal Revenue was $79,519,040.00

2. *Issuance of the Stock*

(a) *Issuance of the Reorganization Stock*

190. On October 5, 1893, 31 years after the original Union Pacific was incorporated, three of its stockholders filed a complaint in the Circuit Court of the United States for the District of Nebraska, alleging that the company would fail to meet its expenses and charges in 1893 by at least $3 million and that the company was insolvent, and asking that receivers be appointed for the entire system. On October 13, 1893, the court issued an order appointing receivers as requested in the complaint.

191. On January 21, 1895, the trustees of the Union Pacific first mortgage filed in the same court a bill to foreclose the mortgage. A decree of foreclosure was issued on July 29, 1897.

192. Under date of October 15, 1895, a committee headed by Louis Fitzgerald published a plan for the reorganization of the railroad. It proposed that a new company (or a reorganized Union Pacific Railway Co.) should succeed to main lines and lands covered by the mortgages included in the plan and that the new company should issue to the reorganization committee $100 million in first mortgage 4 percent bonds, 750,000 shares of $100 par value noncumulative preferred

stock, and 610,000 shares of $100 par value common stock. A major portion of the new securities were to be distributed by the reorganization committee to holders of the securities of the plaintiff's predecessor.

193. On January 29, 1897, the United States filed in the court referred to in finding 228, a bill to foreclose a lien existing under certain statutes against the Union Pacific line from Council Bluffs to Ogden. A decree of foreclosure was issued on July 29, 1897.

194. Pursuant to the two decrees of foreclosure, the railroad (except for the lines and lands of the Kansas Pacific and Denver Pacific) was sold on November 1, 1897, to Louis Fitzgerald and Alvin Krech, as purchasing trustees for the reorganization committee.

195. Pursuant to the decree of foreclosure under the suit filed by the United States, the reorganization committee paid, for the assets involved, $40,253,605.49 in cash, as follows:

October 25, 1897	$2,000,000.00
November 1, 1897	4,100,000.00
December 6, 1897	8,538,401.38
December 16, 1897	8,538,401.38
December 27, 1897	4,000,000.00
December 28, 1897	4,538,401.38
January 6, 1898	8,538,401.35
Total	40,253,605.49

196. Pursuant to the decree of foreclosure of the Union Pacific first mortgage, the reorganization committee paid $50,637,435 for the assets involved. Of this amount, $5,373,249 was paid in cash and the balance was apparently paid by use of the first mortgage bonds deposited with the committee.

197. On January 17, 1898, the purchasing trustees assigned their two bids at the sale to the plaintiff. On January 22, 1898, two deeds were executed, conveying to the plaintiff the property sold on November 1, 1897. One of the deeds was executed by the special master, the purchasing trustees and the predecessor and the other (on the foreclosure under the first mortgage) by the special master, receivers, trustees, the purchasing trustees and the predecessor.

198. Pursuant to the plan of reorganization, plaintiff issued $90 million in first mortgage bonds and the reorganization stock (750,000 shares of preferred stock and 610,000 shares of common stock) to the reorganization committee for money and property acquired by the reorganization committee.

199. On January 31, 1898, in the foreclosure proceeding brought by the United States, the court issued a decree approving and confirming the payment of the purchase price, the assignment of the bid to the plaintiff and the execution and delivery of the deed conveying to the plaintiff the property sold on November 1, 1897.

200. On January 31, 1898, the two deeds of January 22, 1898 and plaintiff's first mortgage were recorded at Omaha in Douglas County, Nebraska.

201. On January 31, 1898, the Mercantile Trust Company, the depositary under the plan of reorganization, advertised that on and after January 31, 1898 it was prepared to issue plaintiff's new securities (its bonds and preferred stock) in exchange for certain old bonds and the purchase money certificates, and on that day the Mercantile Trust Company in fact issued some of the new securities.

202. At midnight at the end of January 31, 1898, plaintiff took possession of the property sold on November 1, 1897, including the main line from Omaha to Ogden.

203. On February 9, 1898, the Mercantile Trust Company advertised that it was prepared as of that date to issue plaintiff's preferred and common stock in exchange for certificates of deposit of the common stock of The Union Pacific Railway Company.

204. The plan of reorganization provided that it could be abandoned by the committee at any time and included a procedure for making substantial changes in the plan.

205. By reason of the events of January 31, 1898, described in findings 199–202, on that day the plan was no longer contingent and could no longer be abandoned or changed substantially.

206. January 31, 1898 is the date of the issuance of the reorganization stock.

(b) *Issuance of the Post-Reorganization Stock*

207. The dates of the issuance of the acquisition stock are as stated in finding 179.

3. *Cash Assessments on Old Stockholders*

208. Under the plan of reorganization of the Union Pacific Railway Company dated October 15, 1895, the common stock was assessed at the rate of $15 per share. A holder of one share of the old common who paid the $15 assessment was entitled to receive one share of the new common plus 15/100ths of one share of the new preferred. In other words each recipient of 1 new share of common was assessed $15; a total of $9,130,275 was received on account of these assessments.

209. As appears in finding 179, the post-reorganization stock—all common—was issued on the basis of 1 new share (acquisition common) for 1 share of Oregon Short Line common plus $3. In other words, each recipient of one share of post-reorganization common was assessed $3. The sum of $815,820.62 was received on account of these assessments.

210. The foregoing cash assessments of $15 and $3 were part payment for the shares being issued or, put otherwise, the shares being issued were issued in part for property and in part for money, the respective cash assessment. The shares were thus being issued for a combination of money and property and as determined in the conclusions of law the money—the cash assessments—is not to be included in equity invested capital in addition to the fair market value of the stock which was issued.

4. *The Expert Witnesses*

211. The value of the stock was the subject of testimony by an expert witness for each party. The direct testimony of these experts was exchanged before trial and the witnesses began their testimony at the trial with cross-examination. Both witnesses qualified as entitled to testify to their opinions.

(a) *Qualifications of the Plaintiff's Expert*

212. Plaintiff offered the testimony of Mr. Alexander Sachs as its expert witness on the stock valuation issues. Mr. Sachs is an independent economist, investment adviser and business consultant. He has not held himself out to the public as an investment adviser and is not registered as such with the SEC.

213. He has testified before this court as a witness for the United States, in a proceeding to determine the value of common stock for purposes of the World War II Excess Profits Tax Act, specifically the value at which such stock should be included in a taxpayer's equity invested capital for purposes of determining its excess profits tax credit. He also has testified before the Federal Communications Commission, the New York Public Service Commission, and the Pennsylvania Public Utilities Commission regarding a fair rate of return.

214. Mr. Sachs was graduated from Columbia University in 1912, and shortly thereafter became an employee of Lee Higginson & Company, an investment firm, working on the effect of the money market on the purchase and issuance of various securities.

In 1915 he undertook studies in jurisprudence and administrative law at Harvard; and in the following year he assisted Mr. Justice Brandeis and Professor Felix Frankfurter in work related to foreign affairs.

215. During the early 1920's Mr. Sachs was employed in studying individual investment situations.

In 1929 he became the chief economist and director of investment research for a diversified investment fund, founded by Lehman Brothers, which ultimately became the Lehman Corporation. As director of investment research for the Lehman Corporation he directed staff members engaged in investment research, and reviewed problems in economics, banking and the economic outlook for particular industries and general economic conditions. He was also a member of the portfolio committee of the Lehman Corporation. He was a director of the Lehman Corporation from 1931 to 1959 and a vice president of that company from 1936 to 1942.

In 1933 he headed the Economic and Planning Division of the National Recovery Administration. In 1956 and 1957 he was a special consultant to the Federal Reserve Board on problems of credit and credit institutions. He has participated in various governmental and industrial committees and conferences.

216. Mr. Sachs has also rendered advisory and consultant services on economic and investment problems as well as on industrial management problems to a major oil company, a mid-western insurance company, a New York bank, a prominent French bank and to various investment management firms.

217. He has at various times been a member of various learned societies, including the American Economic and Statistical Association, the Econometric Society, the Society of Security Analysts, the American Political Science Association, the Royal Economic Society, and the Conference of Business Economists. He has lectured at the University of Virginia, Swarthmore, St. John's College and the Academy of Political Science. Mr. Sachs has not published any books or articles on the valuation of securities. He has published numerous articles in professional journals; the titles and subjects of some are: FINANCIAL DYNAMICS OF U.S. RECOVERY, 1937–38; LOGISTICS PETROLEUM PIPELINE SYSTEM FOR WAR PROSECUTION, 1942; RESTORING ECONOMIC-CULTURAL BASES FOREIGN INVESTMENT, 1950; CRITIQUE OF THE CYCLE THEORY, 1953; INFLATION AS SOURCE AND CHALLENGE, 1958; also chapter contributions to AMERICA'S RECOVERY PROGRAM, OXFORD UNIVERSITY PRESS, 1934; and to MORAL PRINCIPLES OF ACTION, Harper's 1952.

(b) *Qualifications of the Government's Expert*

218. The Government offered as its expert witness on the stock valuation issues, Mr. Arthur Jansen, a general partner of W. E. Burnet & Company, a New York City brokerage firm. Mr. Jansen is a specialist in the analysis and valuation of railroad securities.

219. He has testified as an expert witness in four cases before the Interstate Commerce Commission and one case in this court. His appearances before the ICC were on behalf of railroads or railroad stockholders. One of the ICC cases concerned the division of freight rates on transcontinental shipments. He was retained by a group of eastern railroads to present various financial aspects of ten eastern roads and to make comparisons with seven Mountain Pacific roads. His other testimony before the ICC concerned the fairness of plans of railroad recapitalization or railroad reorganization. His previous appearance in this court was on behalf of the Government with regard to the fair market value at the time of issuance of the preferred stock of a natural gas transmission company, issued in 1929 through 1931 in the construction of a pipeline.

220. Mr. Jansen attended Columbia College and the Columbia School of Business, graduating with a degree of Bachelor of Science in 1927. He has worked for Wall Street firms in investment research since 1930. In 1930 he began research work for a member firm of the New York Stock Exchange. In 1938, he went with his present firm as head of the research department. He became a partner in 1943 and since then has been the partner in charge of research activities.

221. His primary interest has been the railroad industry, an interest dating back to railroad courses he took in college. Since 1937 he has published at least 400 articles in *Barron's*, a widely read financial weekly; in recent years he has contributed four articles a year. About 90 percent of these articles have been on railroads, the remainder having dealt with public utilities and industrials. In the 1940's many of his articles dealt with reorganized railroads, setting values for proposed new securities under varying conditions, and the recovery he foresaw for the bonds of railroads which had been in bankruptcy in the 1930's and the depressed medium-grade bonds of other railroads. For some years he also wrote for his own firm a monthly letter on railroads, devoted mainly to trends in the industry and current developments. For several years in the 1950's he served as editor of the Annual Railroad Survey of "The Investment Dealers Digest."

In connection with his interest in the railroad industry, Jansen has made numerous inspection trips. He has inter-

viewed many railroad executives and carries on extensive correspondence with them. He also attends meetings of the New York Society of Security Analysts on railroad matters and does extensive reading on current developments in the railroad industry.

222. He taught financial analysis of railroads and railroad securities at the New York University Graduate School of Business from 1943 until 1955 or 1956, corporation finance at Columbia in the 1950's, analysis of industrial securities at the American Institute of Banking, and analysis of industrial and public utility securities at a summer course of the Graduate School of Banking of the American Bankers Association.

He is a long-time member of the New York Society of Security Analysts and was chairman of its Railroad Committee from 1948 through 1950. In 1968 he passed the examination of the Financial Analysts Federation to qualify as a Chartered Financial Analyst.

5. *Valuation Dates*

(a) *Plaintiff's Valuation a Valuation as of 1907*

223. Mr. Alexander Sachs, the plaintiff's expert, testified that

(a) "The 749,742 shares of Union Pacific preferred when issued incident to its reconstitutive-reorganization, had a fair market value, as evaluated by contemporaneously governing money rates, related to a 4 percent yield, of $100 per share."

(b) "The 883,357 shares of Union Pacific common stock [a reference to the reorganization common and to the post-reorganization stock, which was all common] when issued incident to its reconstitutive-reorganization, had a fair market value or investment worth, figured conservatively, in the range of $175 to $200 per share."

224. The witness derived his dollar figures for the preferred from a contemporaneous 4 percent money rate and for the common from price-earnings ratios for eight selected railroads during 1901–1907, multiplied by the total earnings per U.P. share as determined by him. The valuations of both preferred and common, however, were a product of the

witness' concept of a "reconstitutive-reorganization" which began in 1893 and ended in 1907.

225. (a) The witness' theory, which he said was held or espoused by no one else, was that only the financial or technical reorganization of Union Pacific took place on January 31, 1898, and that the true reorganization was a "reconstitutive-reorganization," a term apparently coined by him, which ended in 1907, a date vainly sought in plaintiff's post-trial brief to be amended to 1905.

(b) In his prepared direct examination the witness testified, on the subject of the duration and terminal date of the reconstitutive-reorganization, that "the reconstitution was, for all intents and purposes, accomplished at the close of the 1907 fiscal year."

(c) At the trial he testified that "[i]t is a terminal time span, the earliest part of which is the post-Northern securities case and the retirement of the directors of the Union Pacific from the board and the ensuing collaboration between the Northern Pacific and the Union Pacific in the Clearwater district. . . . That date was in 1905, around May, I think, but it extended through the ensuing year . . . through 1906 . . . into the end of the fiscal year 1907."

(d) The testimony of the plaintiff's expert must be taken to be that the "reconstitutive-reorganization" ended in 1907. In part this conclusion is rested on the actual words of the testimony and in part on the substantial reliance by the witness, for his valuation, on earnings of other railroads for the period 1901–1907 as a source of ratios to be applied to earnings per share of the U.P. over the period 1901 through 1907, and on other data with respect to groups of years ending in 1907.

226. The valuations by plaintiff's expert were thus valuations as of 1907, not as of 1898 and not as of 1898 taking into account then foreseeable events. Only if one could in 1898 foresee all events to 1907 could his valuations be described as valuations as of the earlier date taking into account future events so far as then foreseeable.

(b) *Plaintiff's Underlying Theory of a Reconstitutive-Reorganization*

227. The concept of a reconstitutive-reorganization under-

lies the valuation of plaintiff's witness and his utilization of 1907 as the date as of which he valued the stock. This concept is the subject of the following findings.

228. A valuation of the U.P.'s common and preferred shares, the plaintiff's expert testified, requires that full attention be given the following fundamental and readily apparent facts concerning the construction, receivership, and reconstitutive-reorganization of the U.P., which he felt have for the most part largely been ignored in the great body of literature with respect to the road:

(1) The so-called "effective" date for the "financial reorganization" of the U.P. as of January 31, 1898 cannot be utilized as a proper date of valuation of the reorganized company inasmuch as:

(a) The reorganizers of the U.P. were dealing with a company which had become dismembered during the course of its receivership, and did not consider their task of reorganization to have been completed until that point in time when Union Pacific was fully reconstituted into a functioning railroad system. Thus the reorganizers of the U.P. would never have undertaken its reorganization, which involved the expenditures of great sums of money, unless they had been and were assured, among other things, that during the course of, and as a part of, that reorganization the Oregon Short Line and Oregon Railroad & Navigation Company, the U.P.'s gateway to the Northwest, would be reintegrated into the U.P. system;

(b) The pre-receivership competitive challenges thrown up to the Union Pacific Railway by the Chicago, Burlington & Quincy Railroad, which continued to persist throughout the U.P.'s receivership, and culminated in the Hill-Morgan combination of the Northern Pacific and the Great Northern Railroads, constituted a threat to the U.P.'s very survival, a fact which was well known to the reorganizers of that company who in the course of such reorganization were required to, and did, deal with such threat as an integral part thereof;

(c) The threat of the transfer of majority control of the Southern Pacific to a competitor of the U.P. had to be effectively overcome by the reorganizers of the U.P. and until

such threat had been met no true and concise determination of the value of the reorganized company could be made;

(2) The receivership of the U.P. and its various branch and auxiliary lines was not inevitable, but rather was undertaken as a means of solving problems inherent in the original charter of the U.P., which were occasioned by the high cost of the road's construction during the inflationary Civil War years, and which arose from the oppressive burden of the U.P.'s indebtedness to the Federal Government; and

(3) The fact that there was, just prior to U.P.'s receivership, and continuing throughout its ensuing reconstitution, a shift in the ownership of its equity from domestic to foreign holders, who were predominantly British.

229. Plaintiff's expert further testified that the U.P.'s reconstitutive-reorganization was to be distinguished from its financial reorganization, as follows:

(a) The U.P.'s reorganization was singular and distinct from those of other railroad reorganizations which were effectuated during the last decade of the 19th century and the first decade of the 20th century. The preponderance of other railroads reorganized during the aforementioned period remained intact as physical transportation systems during their respective receiverships. Their receiverships were brought about due to an inability to meet creditor obligations. In turn such receiverships were in each case replaced by "financial reorganizations" which were directed towards, and in fact accomplished, a rearrangement of such companies' financial structure in order to meet their creditors' demands.

(b) On the other hand, the reorganization of the Union Pacific was to be contrasted with the said "financial reorganizations," undergone by various railroads. The U.P. did not during its receivership undergo a mere readjustment of its capital structure to meet creditor demands. Rather it was subjected to an extensive dismemberment and disintegration, and therefore the effective date of its "financial reorganization," as of early 1898, applied to only a very small portion of the transportation system which in fact was reorganized. From the standpoint of economic functioning, that small fraction of road, which underwent a "financial reorganization" in early 1898, was in no way related to, nor could it

be equated with, the great system which existed during the U.P.'s pre-receivership years. That integrated system, the true economic entity, was reestablished later through its reconstitutive-reorganization. It was to this great system and not to its component parts that an investor would look. The small fraction of road which resulted from the early 1898 "financial reorganization" was in a state of vulnerability to accentuated competition from neighboring transportation systems, and thus could not have been, nor was it, the economic entity which was the goal of the reorganizers of the U.P. Accordingly, it is to be concluded that as of the date of its "financial reorganization," the U.P. had in fact only begun to embark on its true reorganization, its "financial reorganization" being merely the overture and prelude to the economic reconstitution and real reorganization of its requisite prior parts, and the rehabilitation of its competetive functioning in the post-receivership period. That competition was not only for local and trunk line traffic, but also for transcontinental traffic with competing systems, which systems for the most part had gone through their own individual receivership structurally intact, without the fractionation peculiar to the U.P. Thus while its competitors were reorganized as a unit, the foreclosure of the liens of the Union Pacific branch and auxiliary lines required a multi-step reorganization before the economic unit could in fact be reorganized.

(c) Accordingly, it is to be concluded that the reorganization of Union Pacific was not completed until that point in time when the system had been reconstituted, and the competitive threats which had existed prior to, and during receivership, had been effectively dealt with. The earliest possible point in time at which the reorganization of the U.P. could be considered completed was the latter part of 1905, when friendly relations were restored between the U.P. and the Northern Pacific, continuing to the end of the fiscal year 1907. See also finding 225.

230. It is found that the witness testified that the reorganization was completed at the end of the fiscal year 1907.

231. Plaintiff's expert further testified that

(1) The reorganization of the U.P. necessarily encompassed the reintegration of the Oregon's lines into the U.P.'s system, as follows:

(a) It is to be repeatedly emphasized that the reorganizers of the U.P. from the outset worked to bring about a reconstitution of the system as it existed in the pre-receivership time, i.e., to bring back into the system on a satisfactory basis all of its important branch and auxiliary lines which had been cut off during the receivership, and thereby restore to the U.P. its connection with the Pacific Ocean.

The U.P.'s receivership brought about the complete dismemberment of the system, and its reorganizers had, from the outset, no less a goal than the reintegration into the system of the Oregon Short Line Railroad, the Oregon Railroad and Navigation Company, the Omaha and Republican Valley Railroad, the Union Pacific Lincoln & Colorado Railroad, the Kearney & Black Hills Railroad, the Junction City & Fort Kearney Railroad, the Julesburg Branch of the Union Pacific, Denver & Gulf Railroad, the Carbon Cut-off Railway, the Echo & Park City Railway, the Solomon Railroad, and the Salina & Southwestern Railway.

An important factor leading to the conclusion that the reorganization contemplated reacquisition of the various aforesaid lines of road, was that the prereceivership U.P. controlled or owned some 7,681.72 miles of railroad, of which it had lost during receivership some 5,832.43 miles, which included its connection with the Pacific Ocean, and therefore, as of the date of its "financial reorganization," consisted of only 1,849.29 miles of railroad.

Another important factor of great weight was the manner in which the reorganizers of the road reintegrated the various branch and auxiliary lines, as well as the speed with which such reintegration was accomplished. The 1891 Collateral Note Trust Indenture, to which had been pledged, as security, all of the stocks and bonds of Union Pacific Railway's auxiliary and branch lines, played a large part in the plans of the reorganizers. More specifically, as early as 1895 the reorganizers of the Union Pacific commenced purchasing from the trustee of the 1891 Trust much of the aforesaid collateral, acquiring such securities in the name of the reorganization committee for the account of the new company. All of the various acquisitions made by the reorganization committee from the trustee under the 1891 Indenture were made for the account of the Union Pacific Railroad, the purpose behind

such acquisitions being to reintegrate into the U.P. those profitable branch and auxiliary lines which had been lost during receivership.

(b) The U.P.'s reorganization from the outset looked to the reacquisition of the Oregon lines. In the final settlement worked out between the reorganization committee and the Federal Government with respect to the Government debt, the reorganizers planned to secure for the benefit of the U.P. the various securities of the Oregon lines which were held as collateral in the Morgan-Drexel Trust of 1891.

The reorganization committee from the outset looked to reacquisition of the Oregon lines as part of their reorganization scheme. A failure to carry forward the reorganization plans would have adversely affected many other large affairs and interests in which the reorganizers were involved; particularly the comprehensive plans which had been made by them to recover the lines lost to the old Union Pacific system. plans which included an agreement to purchase the Oregon Short Line stocks, held by the firm of J. P. Morgan under an old trust indenture of 1891. In the fall of 1897 the reorganization committee "had gone too far to be able to retrace its steps." Accordingly, the reorganizers of the road acceded to the demands of the Federal Government, paying in full Union Pacific's indebtedness both for principal and interest.

(c) In about December of 1898 the U.P. announced that it was to absorb the Oregon Short Line through an exchange of its common stock. The act of acquisition of the Oregon lines was not to be regarded as a new development nor as introducing into the reorganization a new factor. It was only the method of carrying out the acquisition which constituted a new feature. The fact that a large block of Short Line stock had been purchased in 1897 by the reorganization committee from the Morgan Trust and was held in the interests of the Union Pacific has been well established for a long time. The investment public had long been aware of the fact that the reorganization of Union Pacific necessarily carried with it a reacquisition and reintegration of the Oregon lines.

232. The plaintiff's expert further testified that the reorganization of the U.P. necessarily encompassed the reor-

ganizers' plans for dealing with pre-receivership challenges to its transcontinental role as follows:

(a) Another major factor, as noted above, in determining the point in time at which the U.P.'s reorganization was completed, was the manner in which its reorganizers dealt with threats to the U.P.'s transcontinental position by competing roads. The first of these threats was the possibility that major control of the Southern Pacific would fall into the hands of a competitor. The second of these threats took the form of the pre-receivership challenges of the Chicago, Burlington & Quincy Railroad, which continued to persist throughout Union Pacific's receivership, and culminated in a settlement between the U.P. and the Hill-Morgan combination. Had not both of these problems been overcome during the course of reorganization, the U.P. would have been reduced to the position of a trunk line without feeders of its own, dependent for freight upon traffic arrangements which it might make with rival systems.

The various groups of security holders within the U.P. system struggled to put themselves in position to form alliances with other systems should the U.P. be broken up. It would be utterly false and erroneous to attempt to evaluate the U.P. as of the date when it emerged from its so-called "financial" reorganization, inasmuch as at that point in time it merely constituted a truncated fragment, nowhere resembling its pre-receivership identity or the entity which its reorganizers, officers and faithful investors envisioned from the outset as the system which would emerge from the true reorganization.

(b) The Southern Pacific and the Central Pacific were important to the U.P. The U.P. in early 1901, put the keystone to its arch through the purchase of control of Southern Pacific, thus permanently assuring to it possession of the Central Pacific connection. By 1901 the U.P. had determined on the purchase of Central Pacific or, in the alternative, the construction of a new line from Ogden to San Francisco. The acquisition by Union Pacific of Southern Pacific was to protect the System from further threats of truncation.

The opportunity afforded the U.P. to acquire a controlling

interest in Southern Pacific must be considered to have been a defensive move on its part to protect the System which was then in the final stages of its reconstitutive-reorganization.

The acquisition of Southern Pacific was to protect and maintain the position of the System, safeguard its future against combinations of other lines, which, should they become hostile, might divert its business by changes in the existing channels of transportation.

(c) With respect to the Chicago, Burlington & Quincy threats, problems arose in the late 1880's between the U.P.'s management and the management of the Burlington. During the period of time wherein the U.P. was attempting to extricate itself from the problems of the Government debt, great obstacles were thrown in its way by the Burlington. The campaign which was waged by the Burlington was calculated to bring about the insolvency of Union Pacific and destroy its transcontinental character.

The challenges thus presented to the U.P. by the Burlington carried over into 1901. This is evident in the fact that the tenure in office of President Perkins of the Burlington did not terminate until 1901. Coupling this fact with the fact that it was during the closing years of Perkins' presidency of the Burlington that the negotiations which culminated in the Hill-Morgan combination took place, leads to the conclusion that there was a connection between the two incidents which was evident to the reorganizers of the U.P.

The acquisition by the U.P. of the preferred stock of Northern Pacific was a protective measure, undertaken to preclude the reduction of the U.P. to a trunk line without feeders. The purchase of a majority interest in the Burlington by the Great Northern and Northern Pacific was an invasion of U.P.'s territory.

The ultimate resolution of the problems created in the Hill-Morgan combination were not effectively dealt with until that point in time at which a settlement between the parties was effected. This did not occur until the Supreme Court ruled on the proper distribution to be made by the Northern Securities Company of the stock and securities of Northern Pacific which it had acquired during the early 1900's.

In the light of the foregoing, it is to be concluded that reconstitution of the U.P. could not be considered complete until the dangers and threats to its transcontinental position had been surmounted. The earliest point in time at which the Burlington threat, as personified in the Hill-Morgan combination, could possibly have been settled was in 1905, when the U.P. and Northern Pacific joined in the construction of some 500 miles of road in the Clearwater District of Idaho, and the time extended to the end of fiscal 1907.

233. The plaintiff's expert further testified that

The Union Pacific's receivership was not inevitable but was undertaken to solve problems inherent in the original charter, as follows:

(a) An understanding of the true reorganization of the U.P. requires a thorough knowledge of the causes which underlay its receivership and its dismemberment during receivership; that not until these factors are firmly understood can a true appreciation of the actual goals of the organizers of the road be possible and not until these goals are appreciated can the reconstitutive-reorganization be understood.

(b) One principal cause of the receivership and subsequent dismemberment of the U.P. was inherent in the original charter of the Pacific Railroads, which denied to the road the legal power to effectuate any meaningful unification of its branch and auxiliary lines. Thus the road lacked the economic flexibility necessary to utilize such unification as a basis for refunding the existing debt obligations at interest rates lower than those with which the road was burdened at the time of original construction. Because of this restriction, the road was denied substantial financial advantages which other competing systems had available.

(c) The earnings power limitations which arose from the U.P.'s charter restrictions were not only known, but were of vital concern to both management and the long term equity investor over the pre-receivership period.

(d) The restrictions and their interrelationship with the problems of the Government debt ultimately led to the U.P.'s receivership. The receivership of the U.P. in 1893 was effectuated more to force a settlement with the Government than from actual necessity.

(e) Other transcontinental systems entered into the field of U.P. competitors. The financial impasse faced by the U.P. prevented unification with its subsidiary companies, and also prevented a refunding of its fixed charges and indebtedness due to the interdictions placed upon changes in its capital construction. The Thurman Act of 1878 required the U.P. to pay over to the Federal Government all of the transportation revenues derived on account of services rendered to the Government, for investment in the sinking fund and for annual payments to be applied on the Government debt.

(f) The charter restrictions are to be related to the extremely high costs incurred in financing the original construction of the U.P., as compared to the lower costs of construction which its competitors were able to take advantage of during the 1880's.

An additional factor underlying the U.P.'s receivership was the advantage available to other railroads, direct competitors of Union Pacific in many instances, to obtain financing at the much lower interest rates which prevailed during the 1880's. The Northern Pacific and Manitoba was built in 1887, and thus enjoyed the advantage of low construction costs, while the U.P. was financed during the post-Civil War inflation at a time when labor and capital were scarce and costs high.

(g) Had the U.P. been free of the constraints inherent in its original charter, it would have been able to refund the excessively high fixed charges which it bore as the result of wartime finance and, therefore, could have guaranteed, without the necessity of refunding through the collateral trust medium, the prior burdens which had been incurred by its branch or auxiliary lines. Furthermore, after other transcontinental systems entered into the field of U.P. competitors, U.P.'s defensive construction, undertaken to counter the competing transcontinentals, could have been accomplished at lower costs, and would not have resulted in excessive rate reductions. Each of the foregoing factors (inability to refund excessively high fixed charges; necessity of utilization of collateral trust financing; high cost of defensive construc-

tion; and excessive rate reduction) were causes of U.P.'s receivership and dismemberment, and the reorganizers of the road during the course of their reorganization had effectively to deal with these factors so that they would never again work to the detriment of the System.

234. The plaintiff's expert further testified that

(a) A second cause of the road's receivership and subsequent dismemberment was the problems arising from the Government debt and the means which had to be utilized in order to meet that indebtedness.

Tracing the U.P.'s obligation to the Federal Government from inception up to and including its ultimate payment in full of that obligation and, for the aforesaid conclusion, using in great part the U.P. annual reports to stockholders for the period which immediately preceded its receivership, it was noted that President Charles Francis Adams, as early as 1887, had adopted a program designed to accelerate a solution to Union Pacific's political and economic problems. Further noted was Adam's reference to the so-called Outhwaite Bill, which was then pending before the Congress, and which would have provided for a refunding of the Government indebtedness for some 50 years at a lower rate of interest. Highly significant was the Adams statement to the effect that the passage of this legislation was prevented only by a small body of opponents, and though it had not yet been enacted into law, represented the views of the United States Government in all of its departments, and the further Adams statement that the company hoped soon to resume payment of dividends.

(b) The defeat of the aforesaid legislative proposal resulted from political, rather than economic reasoning. In support of this conclusion is the fact that during the late 1880's and early 1890's the country experienced a strong Populist Movement whose principal champion was William Jennings Bryan. The convergence of this movement on the political scene, at a time when the U.P. was attempting to extricate itself from problems which arose in the early years of its construction, prevented a final solution from being effectively reached, and necessitated receivership, dismemberment and the reconstitutive-reorganization of the System.

(c) The foregoing conclusions were borne out by the final settlement effectuated with the Government, as well as the immediate prosperity realized by the U.P. System within a short period of time thereafter. The settlement with the Government was not less than brilliant. Referring to the sequence of events which transpired in 1897, and which led up to the final payment in full to the Federal Government of U.P.'s indebtedness in the fall of that year, and particularly events as they concerned the last minute postponement of the Government's foreclosure sale, it was evident that, should further delay have been encountered, serious consequences would have ensued and Union Pacific would not have been able to effectuate its reconstitution. Only through the alliance of the foreign-based bankers, who underwrote the reorganization, and men such as E. H. Harriman was the settlement with the Federal Government accomplished.

(d) In final corroboration of the theory that the Union Pacific's indebtedness to the Federal Government was a major cause which gave rise to its receivership, subsequent dismemberment, and reconstitutive-reorganization, reference was made to the editorial comment which appeared in the *Chronicle* of December 30, 1899, and which dealt in great detail with the U.P.'s annual report for the year ending June 30, 1899, with particular emphasis to the following:

> It is therefore gratifying to find that the offsetting advantages of the new arrangement, whereby the road is no longer hampered by Government interference and the managers are free to carry out whatever policy seems for the best interests of the company, are such as to remove occasion for misgivings in the particular mentioned period.
>
> * * * * *
>
> That the property had a future under a capable and efficient administration, at liberty to pursue its own plans, has never been questioned by anyone competent to express an opinion on the point. Indeed it was obvious that the road had certain distinct advantages over other transcontinental lines.
>
> * * * * *
>
> One real danger threatened the property when it became involved in the financial difficulties from which it

> seemed so hard to extricate it. The danger was that the system would be completely disintegrated, impairing the earning capacity of the main line.
>
> * * * * *
>
> But under the energetic and far-sighted management of those who formulated and conducted the reorganization, and who are guiding the new company's affairs, this difficulty has been avoided. All the most desirable lines, branches and feeders have been secured, and are now being more firmly cemented to the system than before.

(c) *The Valuation Dates Utilized by the Government's Expert*

235. The Government's expert utilized the following valuation dates in his valuations (see findings 206–207):

Reorganization Stock	Valuation Date
610,000 common	January 31, 1898
750,000 preferred	January 31, 1898
Post-reorganization Stock	**Valuation Date**
137,301 common	Jan. 26–Feb. 25, 1899
68,650 common	Feb. 26–Mar. 4, 1899
27,460 common	Mar. 5–Mar. 11, 1899
31,642 common	Mar. 12–June 30, 1899
1,966 common	July 1–Dec. 1, 1899
3,688 common	Dec. 2, 1899–June 30, 1900
2,363 common	July 1, 1900–June 30, 1901

(d) *Conclusions as to Valuation Dates*

236. The date of February 2, 1898, the date of the first trading of the reorganization preferred (finding 344) is, as determined in the opinion, the correct date for determining the fair market value of the reorganization stock.

237. The dates of the issuance of the post-reorganization stock between 1899 and 1901, set out in finding 235, are, as is determined in the conclusions of law, the correct dates for the determination of the fair market value of the respective blocks of post-reorganization stock.

238. The concept of a reconstitutive-reorganization, the basis for the valuations by plaintiff's expert, has no merit whatsoever as affecting the dates of issuance of the stock involved, the correct dates for the valuation of the stock, the entity with respect to which the stock is to be valued, or otherwise, in any way material to this case.

239. The use by plain iff's expert of a valuation date of 1907 was the use of an in orrect valuation date, with the consequence that his valuat on has no material bearing on the determination of the fair market value of the reorganization stock and the post-reorganization stock at the correct dates for valuation.

His valuation has therefore not been considered on its merits at all, either for its correctness as a valuation for 1907, for 1898 or otherwise.

240. The Government's expert did not use correct valuation dates. See finding 236.

6. *The Dollar Valuation of the Reorganization Stock by the Government's Expert*

241. As already indicated, defendant's expert valued the 610,000 shares of reorganization common at $22.50 per share and the 750,000 shares of reorganization preferred at $45.00 per share.

7. *Pre-Receivership History*

(a) *1869—Construction and Capitalization*

242. The Act of July 1, 1862, the first Pacific Railway Act (c.120, 12 Stat. 489), provided for the construction of a transcontinental railroad from the Missouri River to the Pacific Ocean. Plaintiff's original predecessor, The Union Pacific Railroad Company, incorporated by the Act, was to construct the road westward from the Missouri River to the western boundary of the Nevada Territory, where it was to meet and connect with the railroad to be constructed by the Central Pacific Railroad Company of California. The Government would finance part of the cost of construction by issuing to the Union Pacific 6 percent bonds of the United States payable in 30 years, at specified amounts per mile of road constructed. In addition, the Government agreed to transfer to the U.P. land for the right of way plus five additional sections per mile on each side of the track. In turn, the U.P. agreed to pay the bonds at maturity and to reimburse the Government for the interest. To secure the repayment to the Government of the amount of the bonds and the interest thereon paid by the Government, the Government was given

a first mortgage on all the property of the U.P. In addition, all compensation for services rendered to the Government and at least 5 percent of the net earnings of the road were to be applied to payment of the bonds and interest thereon.

243. These provisions failed to induce sufficient interest in the proposed construction and the road was unable to raise private capital. Not until Congress amended the law in 1864 (Act of July 2, 1864, c.216, 13 Stat. 356), subordinating the Government to a second lien position and granting substantially increased benefits to the road, did it become feasible to go ahead with the project. Specifically, under the amendatory act the land grant was doubled, the number of alternate sections on each side of the line granted per mile was increased from five to ten and the limits within which these sections were to be granted were increased from a distance of ten miles from the line to twenty miles. In addition, the road was authorized to issue its own first mortgage bonds in an amount not to exceed the Government bonds. Also, only half, instead of as formerly the whole, of the compensation for services to the Government was now required to be devoted to payment of the Government bonds and interest.

A still further amendment, on July 3, 1866 (c. 159, 14 Stat. 79) transformed the construction of the Pacific Railroad into a race between the U.P. and the Central Pacific, each to build in a continuous line until they should meet and connect. Land grants were the prize.

244. In 1866 the Union Pacific began construction westward from Omaha, Nebraska, while the Central Pacific built eastward from Sacramento, California. The historic meeting of the two took place in 1869 at Promontory, Utah Territory, 54 miles west of Ogden. The two roads subsequently agreed upon a point five miles west of Ogden as the connecting point from the standpoint of traffic interchange, the Union Pacific selling to the Central Pacific its line west of the agreed point. On this, the Union Pacific had about 1.038 miles of road.

245. The cost of construction to the Union Pacific was very high due to high prices prevailing during the construction period, the speed of construction, and the method of financing employed. As was common practice, the U.P. used a construction company. The owners of the company, Credit Mobi-

lier of America, were the directors and stockholders of the road itself, as was again common practice. In consequence there was a built-in incentive on the part of the road to maximize the payments for construction and thus the profit accruing to the Credit Mobilier at the expense of the U.P.

The Credit Mobilier received, for the road, the maximum amount of bonds provided by the Government and an equal amount of the U.P.'s first mortgage bonds, along with substantially all of the road's common stock. The sale of these bonds essentially provided the funds for the actual cost of construction, while virtually the entire common stock of the railroad was distributed to the stockholders of the Credit Mobilier. The construction cost stated in the U.P.'s 1870 balance sheet, immediately after the completion of the road, was $97.3 million, while the actual cost of construction to the Credit Mobilier was only about $54.2 million. The profit to the Credit Mobilier was $23.4 million in terms of the market value of securities and cash.

For the $36.8 million in par value of stock issued by the road, it received in cash only $400,650, the balance of the stock constituting a bonus of profit to the Credit Mobilier. As a result, there was no true equity for the common stock, in today's sense of that term.

246. The road had net earnings of $58,357,133 during the period 1870–1879, some of it resulting from charging to construction items chargeable to operating expenses. Interest charges for the same period were $49,438,109, including the interest on the Government debt. Since the latter was not payable until maturity, there was income available for dividends, and dividends in the amount of $11,942,125 were paid from 1875 to 1880.

As time went on, the practice of not providing from earnings for the interest to be due to the Government in the future contributed to the inability to provide for the maturing debt, which by the time of the reorganization amounted to $58.448.223.25 for principal and interest, and was paid in full, on September 30, 1898, as part of the reorganization plan.

(b) *Expansion: Mergers*

247. In 1880 the U.P. was consolidated with the Kansas Pacific, from Kansas City to Denver, Colorado, and the much

smaller Denver Pacific, from Denver to Cheyenne, Wyoming, at the U.P.'s main line. The two new railroads added 750 miles to the U.P.'s 1,038 miles.

248. Stock was added to stock and bonds to bonds, the consolidation increasing U.P.'s stock by $14 million, from $36.7 to $50.7 million, its bonds $38.4 million, from $88.4 to $126.8 million, and its miscellaneous debt $5.7 million from $4 to $9.7 million.

249. A large part of the new securities issued went to Jay Gould, in exchange for stock he had acquired. The U.P. was forced to pay hold-up values to Gould, who had managed the consolidation while he was a director of the U.P. According to the report of the United States Pacific Railway Commission (in evidence; see finding 266), pp. 54–65, Gould brought the consolidation about by threats and other methods which, apart from their propriety at the time, would today be regarded as extremely improper. Some of Gould's stock he had acquired at low prices. In other transactions, in the course of his threatened plan to build a competitor of the U.P., he had acquired branch lines at extraordinarily high prices, much greater than value. These lines he was now able to transfer to the consolidated U.P. at the inflated prices he had paid.

250. The Kansas Pacific was a bond-aided railroad, but the aid had been given only to the 100th parallel, a distance of 394 miles. Some $6.3 million in Government bonds were issued, and sold for almost full face value. Upon completion of the road, the Kansas Pacific had issued $32,088,950 of securities, of which $9,437,950 was represented by stock and $22,651,000 by bonds bearing interest at 6, 7 and 8 percent.

251. Records are not available to show the true cost of the Kansas Pacific, but, on the basis of the Union Pacific's experience of construction costs somewhat smaller than the actual issuance of bonds, a reasonable estimate of the actual cost of construction is approximately $22.6 million, the par value of the bonds issued, or about $32,000 per mile. Subsequently the Kansas Pacific issued funding mortgage bonds to take care of unpaid coupons on defaulted issues, thereby increasing its bonded debt by $1,500,000. At the time of consolidation, the Kansas Pacific had an accumulated deficit of

$6,525,069 after fixed charges. Interest on the Government debt, as in the case of the U.P., not payable until maturity, amounted to $4,805,703.

252. The Kansas Pacific had just then emerged from its chronic insolvency (in substantial part due to the reduction in its rates in the course of its fierce competition with the U.P.), and an intelligent and skillful reorganization of its affairs and a recent large improvement in its business had enhanced largely the value of its securities. Nevertheless, there was little to justify the conclusion that its earning power was such as to expect that it could pay a dividend, except, perhaps, that its new relationship with the U.P. might mean a cut in its losses.

Its outstanding bonds were worth considerably below par value and its common stock was of little intrinsic value.

253. The capital of the Denver Pacific consisted of $2.5 million in bonds and $4 million in stock. Records from which construction costs might be learned, the United States Pacific Railway Commission reported in 1887, were missing or unintelligibly kept, and the Commission could not determine the cost of construction other than to note that the construction account was the $6.5 million capitalization. The minority commissioner of the United States Pacific Railway Commission estimated construction cost at $2.5 million. In the light of the practice of the period of using construction companies owned by the stockholders of the railroad company and the practice of issuing stock as a bonus, a reasonable estimate of construction cost is $5 million. The road had had poor earnings and at the time of the consolidation it had a deficit of half a million dollars.

The stock of the Denver Pacific had therefore little or no intrinsic value, other than the road's value as a connecting link between the Kansas Pacific at Denver and the Union Pacific at Cheyenne.

254. By such standards as asset value and earning power, therefore, the consolidation was unfavorable to the U.P. The three roads had much water in their statements and in terms of capital structure the consolidation led to still further inflation of the capital of the predecessor of the present plaintiff.

There is, however, another point of view. The Kansas Pacific and the Denver Pacific had been the main source of the U.P.'s competition prior to the merger. The fierce competition had almost ruined the Kansas Pacific and severely damaged the U.P. The consolidation had the significant benefit to the U.P. of an end to the competitive wars and an enlargement of its system, both all but indispensable in that era for the U.P.'s survival.

(c) *Expansion: Construction*

255. Between the consolidations of 1880 and the receivership in 1893, the U.P. embarked upon a period of extensive construction. The construction was undertaken through subsidiary companies because the road itself was unable to build additional mileage under the Pacific Railway Acts, specifically the prohibition contained in section 4 of the Act of March 3, 1873 (c. 226, 17 Stat. 509) to the effect that (with minor exceptions here inapplicable) no new stock could be issued nor debt incurred with respect to the property or future earnings of any of the Pacific railroads, without leave of Congress.

256. To initiate the program of construction of branch lines, the U.P. sold an additional issue of $10 million of stock in 1880 and 1881 at par value.

257. Jay Gould, then a director of the U.P., was much involved in the construction of these branch lines. According to the minority report of the Pacific Railway Commission, Gould is estimated to have acquired a fortune of around $40 million, much of it through his dealings in and with the U.P. Some $10 million of this sum were said to have been realized from construction activities in the period immediately following the consolidation of 1880.

Mr. Gould's connection with the road ceased in 1883. The new management was honest, intelligent and energetic. Thereafter construction was economical.

258. Under new management, an even more ambitious acquisition and construction program took place, from 1883 to receivership in 1893. New lines were built with economy and without personal impropriety of the directors, albeit with watered stock. For instance, in the most ambitious proj-

ect of all, the construction of the Oregon Short Line, book capitalization was $29 million but the cost of construction by third parties, under contract, was "less than $15 million." Bonds were issued to finance the construction, and sold at face value. For every $1,000 bond sold at par, the subscriber received without cost $500 in stock. Half the stock issued was so disposed of and the other half was issued to the U.P. without consideration, which retained it to secure control. There was thus a great deal of water in the capitalization, though more was doubtless realized on the bonds than might otherwise have been obtained.

259. The greatest difficulty caused by the 1880–1893 construction and acquisition program, which was no bonanza for earnings at the time, was the burdensome capitalization and a large floating debt to service the capitalization, which was a contributing factor to the insolvency in 1893. The program was, however, more or less forced on the road from the growing competition east of Ogden, and but for the extension of the System from Ogden, the parent road might have encountered financial difficulties because of competition. The program thus staved off trouble earlier than 1893. And by building a wider system, the program no doubt contributed to the long-range (post-receivership) profitability of the U.P.

(d) *Growth of Competition*

260. Prior to the consolidation of 1880, the U.P. had competition mainly from the Kansas Pacific and its affiliate, Denver Pacific. The sharp rivalry resulted in depressed rates and was to a considerable extent responsible for the chronic financial difficulties of the Kansas Pacific. As a result of the consolidation, the competitive situation was corrected and rates were restored to satisfactory levels.

261. In the years immediately after 1880, however, nine railroad companies entered the territory east of Ogden and four additional lines were built across the continent. In the 1870's and 1880's, the controlling interests in the Central Pacific, which connected with the Union Pacific at Ogden, constructed a competitive route from San Francisco to New Orleans, reached in 1883, with connections by water to New York. As a result some traffic was diverted from the northerly, Central Pacific-Union Pacific route to the southern route, thereby in effect breaking the monopoly the U.P. had on transcontinental traffic up to that time.

262. Completion of the construction of the Denver and Rio Grande in the 1880's ushered in further competition between Denver and Ogden. Extension of the Chicago, Burlington and Quincy from Kansas City, St. Joseph and Omaha westward to Denver during the same period also brought this line into the U.P.'s territory. Additional construction by the Burlington northward to connections with the Northern Pacific further sharpened competition. In the same era, the Rock Island Railroad added very greatly to its mileage by building lines from Omaha and Kansas City to Denver. In addition, the Atchison, Topeka and Santa Fe Railroad Company constructed or otherwise acquired about 6,500 miles of road, including some mileage in U.P.'s territory, and more particularly it became a transcontinental competitor when it reached the Pacific Coast in 1885. The Northern Pacific and Great Northern also joined the group of transcontinental carriers, the former being completed in 1883 and the latter in 1893.

263. The tremendous increase in competition led to rate-cutting which impaired the earning power of the U.P. Rebates were given to favored shippers and discrimination in favor of certain shippers and communities was commonplace. In order to improve their lot, the railroads, including the U.P., entered into pool agreements with other roads to shore up rates and share revenues. These practices were engaged in by all the roads as necessary for their economic life, and were not necessarily corrupt or improper.

264. The U.P. was not merely subjected to a great deal of competition; it created a great deal itself. Its construction of the Oregon Short Line and the latter's leasing of the Oregon Railroad and Navigation Company were planned to give it a route to the West Coast so as to minimize the use of the Central Pacific. With the empire being built by the Central Pacific and the Southern Pacific from Portland, Oregon, to New Orleans, Louisiana, the U.P. undoubtedly was put in the position that, in order to survive, it had little alternative but to continue building branch mileage.

(e) *The United States Pacific Railway Commission*

265. Recognizing the imminence of the maturity of the debt owed the United States, Congress in 1887 established the United States Pacific Railway Commission, and authorized it to investigate the books, accounts and methods of railroads which had received aid from the United States and to determine, among other things, whether it would be to the best interest of the Government to extend the maturity of the debts owing to the United States. c. 345, 24 Stat. 488.

266. On December 1, 1887, the Commission, whose members were appointed by the President, delivered its report. A majority report was made by Commissioners E. Ellery Anderson and David T. Littler and a minority report by Commissioner Robert E. Pattison. The report is in evidence as plaintiff's exhibit 413 and is cited herein by name.

267. In addition to its original excessive funded debt and burdensome fixed charges, the road had by 1884 incurred an additional $10 million in floating debt in the mileage expansion beginning in 1880. Moreover, in the period leading up to 1884, earnings were in a declining trend; dividends were omitted in 1884, and were not resumed in the remainder of the time of the receivership in 1893.

268. Beginning in the spring of 1884, the new management of the road devoted itself, by economy and application of earnings to the reduction of the debt and the betterment of the System, in an endeavor to put the road on a sound financial foundation. The new management was successful in eliminating the floating debt, but the basic problems of the road's original capitalization remained.

269. The Pacific Railway Commission approved highly of the U.P.'s new management. The U.P., the Commission reported; "has been entirely extricated from the difficulties which surrounded it at the close of 1883, and stands today as a solvent corporation, in excellent physical condition as to all of its construction, well equipped, and promising excellent results in the future." There is no reason to doubt this judgment.

(f) *Economic Conditions—1869 to the Panic of 1893*

270. During the first four years following completion of the U.P. in 1869, the nation experienced reasonably good

business and the territory served by the road probably enjoyed above-average conditions. The very existence of the U.P. brought growth with it as population flowed in from the East and immigrants began coming to the United States in increasingly larger numbers. At the same time, prices of such farm products as wheat and corn, important crops in the territory served, were maintained at good levels, even though they were far below the abnormally high points attained during the Civil War. Beginning with the Panic of 1873 and extending through 1879, the country went through the long depression of the 1870's. Wheat and corn prices declined moderately from 1875 to 1880, according to United States Department of Agriculture statistics, but the extensive opening of the West left the U.P.'s territory relatively untouched by the depression and the road's revenues continued to grow.

271. In the 1880's wheat and corn prices averaged somewhat lower again, but bountiful crops created generally good conditions. As the decade was coming to a close, however, drought and insect plagues in the United States, recovery in European agriculture, and the development of new growing areas, especially for wheat, in such countries as Canada, Australia, and the Argentine, brought about agricultural depression in the United States. Wheat fell from 95 to 53 cents (prices given here are yearly averages) per bushel from 1880 to 1893; corn fluctuated in the 1880's and finally dropped from 50 to 36 cents per bushel from 1890 to 1893.

272. The steady erosion of farm prices between 1890 and 1893 and the concomitant reduction in demand for the products of industry precipitated the Panic of 1893. Purchasing power of workers declined along with the fall in farm prices, and in the short period 1890–1893, wages received were decreased over one-third. Thus was ushered in a nation-wide depression that was to last for several years. Although corn prices enjoyed a sharp recovery in 1894, generally speaking farm prices remained low—wheat until 1896 and corn into the late 1890's or even later.

273. The Panic of 1893 was followed by a long period of business depression in the territory served by the U.P. In the years prior to 1893, this area had enjoyed a boom based on

easy credit. Thousands of newcomers, many of them with very little agricultural knowledge or experience, had bought land at inflated prices, borrowing on it all the money they could get. Speculative syndicates bought immense tracts of land, mortgaged them for more than they were worth, cut them up into farms and sold them, or tried to sell them, to immigrants from the East. Even the established farmers borrowed millions of dollars on their holdings for the purpose of building houses and barns, acquiring additional land or purchasing live stock and machinery. Cities and towns in the agricultural area outgrew their former boundaries and expanded widely in suburban development.

274. When the Panic of 1893 came, with a sudden contraction in credit and a general loss of confidence in everything and everybody, the financial structure collapsed. Interest payments on speculative loans ceased; mortgages were everywhere foreclosed; farmers were unable to meet their engagements and a period of general embarrassment and distress followed the period of prosperity. The great tracts of land bought by speculative syndicates were no longer saleable and remained uncultivated; town sites were abandoned, and municipalities which had floated loans in the East ceased to exist, leaving the holders of their bonds to foreclose on deserted town lots and empty buildings. Settlers could no longer obtain bank accommodations; solvent businessmen suffered great losses from the sudden shrinkage in values; and even the population decreased as ruined farmers and unemployed farm laborers drifted back into the eastern states.

275. During the erosion of agricultural prices that started soon after Appomattox, discontent arose in the farm areas. Though there were periods of considerable prosperity because of bountiful crops, agricultural machinery, equipment and tools commanded high prices due to high tariffs and monopoly controls. In addition, property taxes were burdensome and interest rates were high, ranging from 7 percent to 10 percent and even higher as a result of special charges. To add to the difficulties of the farmers, especially those in the western states, Congress in 1873 prohibited any further coinage of silver. Passage of the Bland-Allison Act in 1878,

providing for limited coinage of silver, proved to be comparatively ineffective in strengthening farm prices.

276. The agrarian discontent found reflection in the Populist movement, called "the emphatic political expression of agrarian revolt," which had its origin in "Farmers' Alliances," though it also enlisted the support of industrial workers adversely affected by the depression which began in 1893. The Populist movement reached its peak in 1896; but when the Democratic Party nominated William Jennings Bryan as its candidate for President after his stirring "Cross of Gold" speech, the Populists embraced and supported his free silver program and other reforms.

8. *The Receivership of the U.P.—1893–1898*

(a) *Causes*

277. The predecessor Union Pacific went into receivership on October 13, 1893, a victim, with many other roads, of the Panic of 1893. Its financial troubles dated back to its capitalization, both original and as worsened by the consolidation in 1880.

278. With each passing year, the road was coming closer to the period when it would have to face up to heavy debt maturities, including publicly held bonds, as well as obligations due to the United States Government and interest thereon.

The principal early maturities of the predecessor held by the public at the close of 1892 were as follows:

Union Pacific Railroad Sinking Fund 8s 1893	$5,176,000
Union Pacific Railway Collateral Trust 6s Notes 1894	15,793,000
Kansas Pacific 1st Mortgage Eastern Division 6s 1896	2,240,000
Union Pacific Railroad Omaha Bridge 8s 1896	728,000
Kansas Pacific 1st Mortgage Division 6s 1896	4,063,000
Union Pacific 1st Mortgage 6s 1896–1899	27,229,000
Kansas Pacific 1st Mortgage Denver Extension 6s 1899	5,887,000

Debt owed to the United States Government and due in the years 1895–1899, thirty years after it originally was incurred, amounted to $27,236,512 for the U.P. and $6,303,000 for the Kansas Pacific, a total of $33,539,512, exclusive of net interest accrued after deduction of the sinking fund established by law to meet the payments due the Government.

279. In summary form, the obligations of the U.P. at the 1880 and 1892 year ends were as follows:

	Dec. 31, 1880	Dec. 31, 1892	Increase
Funded debt	$82,623,114	$85,492,185	$2,869,071
U.S. Government debt	33,539,512	33,539,512	
Interest on Government debt less sinking fund	12,133,975	17,784,764	5,650,789
Total systems debt	128,296,601	136,816,461	8,519,860

280. Interest charges of the U.P. System in 1892 amounted to $5,371,587, exclusive of interest on the United States Government debt, compared with $5,288,788 in 1880 and $4,914,671 in 1881. In addition, interest requirements on the Government debt amounted at 6 percent per annum to $2,011,920 annually.

281. The direct causes of the U.P.'s receivership were the collapse in business conditions in the second half of 1893, sometimes called the Panic of 1893, and the expectation of a $3 million deficit for the year, after fixed charges.

Longer-range causes were the high cost of construction, the size of the debt owed to the Government, the restrictions on the road's financial freedom imposed in its charter to protect the Government, the burdens assumed in building branches, the debt assumed in the construction following the mergers in 1880, and the rate reductions and other measures undertaken to meet the competition of transcontinental roads.

(b) *Settlements*

282. The receivership continued from 1893 to 1898. The receivers were three in number at first, then five. Of the five, two specifically represented the United States Government, with a third also in something of a quasi-public role.

283. Shortly after the receivership began, a reorganization committee came into being at the instance of various classes of the road's security holders. Mr. J. Pierpont Morgan subsequently was added to the committee and proved to be a dominant force in its decisions. This committee tried for two years to obtain approval of its successive reoganization plans, but the recalcitrance of Congress to the working out of a solution for handling the Government debt (eventually paid in full) caused it to abandon its efforts in March 1895. Mr. Morgan retired, disgusted with what he regarded as political intriguing which had blocked reorganization.

284. In the period of the first reorganization committee, the U.P. System shrank from 8,167 miles of road to 4,469 miles, with further shrinkage in prospect, in largest part due to the loss of branch lines of the U.P.'s system.

285. At this juncture, Mr. Winslow S. Pierce, chairman of the board of directors of the U.P., induced Mr. Jacob H. Schiff and his firm, Kuhn, Loeb & Company, to undertake reorganization. Mr. Schiff created a strong reorganization committee, including such influential people of the era as Mr. Chauncy M. Depew, president of the New York Central, and Mr. Marvin Hughitt, president of the Chicago and North Western Railroad, both regarded as associates of Commodore Cornelius Vanderbilt, prominent railroad magnate. The association in the public mind of the reorganization committee and such outstanding figures in the railroad world proved to be a constructive influence.

286. Undoubtedly, the biggest problem of the reorganization committee was to find a solution to the question of meeting the debt plus accrued interest owed to the United States Government. The Government proved to be a hard bargainer, for even after agreeing to accept $50 million for its claim, in late October, 1897, it refused to abide by its agreement. The reorganization committee then agreed to pay the Government in full, principal and interest, on the debt due on the original Union Pacific Railroad mileage—a total of $58,448,224, including the sinking fund of $18,194,618. On February 12, 1898, the committee also agreed to pay the principal amount of $6,303,000 due on the Kansas Pacific debt owed to the Government, but refused to pay the $6,588,900 of accrued interest. The latter sum, plus interest on this amount, remained as a claim against the receivership estate and ultimately was settled at $821,898.

The Government received a total of $65,573,122, far more than the reorganization committee or the Government directors on the Union Pacific board had had in mind as a probable settlement. For its second mortgage position, the Government appears to have come off quite well in being paid in cash for its entire claim against the main line and a substantial part of its claim against the Kansas Pacific.

287. In contrast with the liberal treatment obtained by the Government in the reorganization, holders of U.P.'s first

mortgage bonds all agreed to make the sacrifices of a long-term extension—to 50 years—of their maturities, and a reduction to 4 percent in the rate of fixed interest to which they were entitled. On the old bonds the interest rates had been for the most part 6, 7 and 8 percent. In compensation for the extension of the maturity date and the reduction in interest on these new bonds, all bondholders other than the Government were given a substantial increase in principal, receiving new $100 par 4 percent preferred stock. They (the bondholders included in the reorganization) received (without other payment therefor) new preferred stock to the extent of at least 50 percent of the principal amount of bonds held; no class of old bonds received in new bonds and preferred stock together less than 150 percent of the par value of the old bonds, with a few minor exceptions. Holders of $36,440,950 publicly held bonds received in the aggregate $29,719,960 par value of new bonds, along with $26,841,775 in new preferred stock, a total of $56,561,735 in new securities, or 155.2 percent of the par value of the old bonds.

(c) *The Reorganization Plan*

288. In sum, the reorganization plan of the U.P., as finally adopted, provided for the issuance of $90 million in first mortgage and land grant 4s 1947 bonds, $75 million or 750,000 shares of 4 percent noncumulative preferred stock of $100 par value and $61 million or 610,000 shares of common stock of $100 par value. New common stock having a par value of $60,868,500 was delivered to holders of the common stock of the predecessor who paid an assessment of $15 per share. See finding 208.

As stated above, $29,719,960 par value of the bonds and $26,841,775 par value of the preferred stock were issued to bondholders of the Union Pacific Railway Company, other than the Government and collateral trust issues. Of the remaining securities of the reorganized company, $52 million of the bonds and $24,666,667 par value of the preferred stock were issued to the Purchase Money or Reorganization Syndicate in settlement of net cash advances of $46,940,000. Another $6,250,000 par value of the preferred was issued to the Purchase Money Syndicate and bankers as compensation

for their claim of $2,500,000 for services, a sum which on division by the 62,500 shares issued gives a product of $40 per share. Another $2,122,000 par value of the preferred was paid to holders of Union Pacific 6 percent Collateral Trust Notes for the right acquired by the reorganization committee to purchase the collateral. Still another $9,103,658 par value of the preferred was issued at par to holders of the common stock of the predecessor for their payment of the cash assessment. The balance of the new securities were sold by the reorganization committee for cash or retained by the committee.

289. (a) The defendant's expert testified that

The issuance of 62,500 shares of preferred to the Purchase Money Syndicate and bankers as compensation for their claim for $2,500,000 for services was a valuation of the preferred at $40 per share.

(b) It is found that

The services of such a committee as was here involved are not ordinary personal services and are not purchasable in a competitive market. It would be more correct to think of the committee and the Syndicate as selling an asset going into the reorganization, for a block of stock. While the division of the shares into the dollar amount gives a seeming dollar figure per share, it is wholly artificial and the figure is not a market valuation or a valuation material in determining fair market valuation.

290. After commissions, the reorganization committee actually received $8,582,458.50 in cash as assessments on the old common. It should not be assumed that no other consideration was received for the $75 million in preferred stock issued in the reorganization. A great deal of legitimate work unquestionably was performed by the reorganization committee and the Purchase Money Syndicate obligating itself to take large blocks of the new securities.

291. (a) The defendant's expert testified that

By no stretch of the imagination, however, could their services have been worth more than several million dollars, allowing for the risks assumed by the Purchase Money Syndicate and compensation in lieu of interest for the money furnished to the reorganization committee. In any event, the capitali-

zation of the reorganized company, as stated on the books, was increased out of all proportion to the value of the services rendered. It should also be pointed out that had the U.P., through sound operation and financial management, been a prosperous and solvent railroad, it would have been able to refund its bond maturities of the 1890's, including the Government lien, at the low interest rates prevailing during the period and thereby have avoided completely the issuance of any new fictitious capital.

(b) The testimony that the services of the reorganization committee and the Purchase Money Syndicate were "by no stretch of the imagination . . . worth more than several million dollars" is not accepted. It is vague, subjective, unspecific and undocumented. The services of such committees are unique and costly. They were moreover presumably approved by the reorganization committee. No basis, intrinsic or extrinsic, appears for the derogations by the witness of the value of the services.

The testimony that the U.P. could have avoided the issuance of any "new fictitious capital" had it been a prosperous and solvent railroad through sound operation and financial management is also not accepted. Many railroads went into reorganization at the time. The Panic of 1893 was not the fault of the U.P.'s management. The U.P.'s insolvency had roots as far back as the original conditions upon the Government's assistance. Insolvency and reorganization were the facts. The reorganization plan was a good one and successful, and made it possible for the U.P. to proceed to profitable operation, free of the burdens of its past. It was to be expected that there would be substantial payments for the additions to value brought about by the reorganizers and their committees and syndicates in the form of capital stock paid to the reorganizers, stock which proved not to be a burden on the company.

Finally, in view of the foregoing, the witness' further conclusion—that the capital of the reorganized company was increased disproportionately—is also not accepted.

(d) *The End of Reorganization, January 31, 1898*

292. The Union Pacific emerged from receivership at midnight at the end of January 31, 1898, with the acquisition by

the present plaintiff, the taxpayer, from the reorganization committee of the property sold on foreclosure, including the main line of 1,043 miles from Omaha to Ogden, Utah. On April 1 of the same year, the road reacquired the 806 miles of the lines of the Kansas Pacific.

293. No balance sheet was included in the annual report of the predecessor U.P. for the year ended December 31, 1897, and it is thus impossible to determine the amount of any property write-up between December 31, 1897 (a date close to the January 31, 1898 effective date of the reorganization) and June 30, 1898, the date of the first balance sheet of the reorganized company, the taxpayer.

Comparison of the balance sheets for December 31, 1896 and for June 30, 1898 shows that in the elapsed year and a half road and equipment had been written up, as of the latter date, $65.9 million, from $155.4 million to $221.3 million.

The 1896 report also contained separate or additional items labeled "Receivers Union Pacific Railway Co., Property Account, $3,787,203.71" and "Land Contracts, Land Cash, etc., $6,171,303.43." The first of these two items, to the extent acquired by the taxpayer, may have been included in the property account of the taxpayer. Whether the land assets of the predecessor were included in the road and equipment account of the taxpayer on June 30, 1898 is not clear, but presumably they were not. The item does not otherwise appear in the 1898 balance sheet. The land assets did not show up until June 30, 1899, when they were reported as follows: "Land Assets, $3,002,232.29."

294. The reorganized road disclosed in its first balance sheet, dated June 30, 1898, that the following securities were outstanding: funded debt of $90 million, $75 million 4 percent noncumulative preferred stock of $100 par value, and $61 million common stock of $100 par value.

295. The reorganization meant a great improvement in the condition of Union Pacific at the time of the reorganization in 1898. All debt was consolidated into one long-term issue, and by the same token there was no problem of short-term or floating debt, which in that era often was a threat to solvency.

296. The emergence of the U.P. from reorganization, more-

over, came at the beginning of a wave of prosperity for the nation and particularly for transcontinental railroads.

(e) *Receivership and the U.P.'s Branch and Subsidiary Lines*

297. The branch line system had disintegrated rapidly during receivership. As the U.P's trustees defaulted on interest payments on the road's collateral trust issues, which were secured by pledges of securities of the branch line subsidiaries, the trustees under the indentures sold the collateral. In 1893 the trustees under these indentures sold collateral consisting of securities of 13 branch lines with a par value of $5.2 million and a book cost of $4.9 million. In turn the subsidiaries went into receivership.

Without these branch and subsidiary lines, a reorganized U.P. would be a truncated main line railroad. The reacquisition of these lines, following their and the U.P.'s reorganization, was of the utmost importance to the reconstitution of the pre-receivership U.P.

It is not entirely clear, and not material, whether the defaults on the securities which put the branches and subsidiaries into receivership were in the ultimate sense voluntary or involuntary. One view is that the defaults were involuntary—that the money was simply not available. Another view is that defaults would in any case have been allowed to happen, to force a reorganization of the branches and subsidiaries, all separate corporations, which would purge them of their heavy debts and shrink their watered capital.

298. Whichever view is correct, it was the underlying intention and plan of those prominent in the affairs of the U.P.—receivers, reorganizers, investors, bankers and prospective leading figures in the new company—to keep close and friendly contacts with the former branches and subsidiaries of the U.P. in order to protect the U.P.'s traffic and then to reacquire those branches and subsidiaries for the U.P. to reconstitute the U.P. network. In pursuance of this plan, the U.P.'s reorganization committee took an early part in the reorganization of the former branches and subsidiaries and purchased interests in them.

299. In this way or another, most of the branch and subsidiary line mileage (except for a good part of the mileage

of the Union Pacific Denver and Gulf) was reacquired by the U.P., most of it shortly after consummation of the receivership in January 1898, the rest in 1899. Most of these lines were reacquired from the U.P.'s own reorganization committee, which had acted on behalf of the new corporation (the present taxpayer), which would take over the U.P. property.

9. *Post-Reorganization Prosperity*

(a) *National Prosperity*

300. With the defeat of Bryan in 1896 and the election of William McKinley on his (or Mark Hanna's) strong endorsement of the gold standard, high tariffs, and support of business, the nation emerged from a period of political uncertainty and moved into an era of generally sustained and rising prosperity until the Panic of 1907.

301. In marked contrast to earlier times, the years after the reorganization of the Union Pacific were very prosperous. Between 1900 and 1910, the population of the trans-Missouri states increased about 40 percent, while the increase in the value of farm lands along the lines of the Union Pacific ranged from 100 to 353 percent. This enhanced value of farm lands was partly due to better and more extensive cultivation, and partly to a greatly improved railroad service which enabled the farmers to send their crops cheaply and promptly to markets where there was an active demand for them. The annual value of these crops, in the states directly tributary to the Union Pacific, increased in the decade 1899–1909 by percentages that ranged from 89 to 235.

302. Agricultural crops, however, were not the only western products that needed transportation. In the revival of business that followed the reorganization of the U.P., industrial activity increased rapidly in all the far western states, and between 1900 and 1910 the annual value of manufactured products in Union Pacific territory rose from $257,000,000 to $530,000,000 in California; in Colorado from $89,000,000 to $130,000,000; in Idaho from $3,000,000 to $22,000,000; in Kansas from $154,000,000 to $325,000,000; in Nebraska from $13,000,000 to $199,000,000; in Utah from $18,000,000 to $62,000,00; and in Washington from $71,000,-

000 to $221,000,000. This group of states alone, in 1909, produced manufactured goods valued at $1,500,000,000, as well as farm crops to the value of $672,000,000 more.

303. Business conditions were given further sharp stimulus with the involvement of the United States in war with Spain in 1898. Then upon its conclusion, annexation of the Philippines by the United States—and the unrelated annexation of Hawaii—resulted in a tremendous expansion of trade with these new territories. In addition, trade with the Orient generally rose to a substantial degree. This was of especial benefit to the transcontinental railroads. In the 1900's, prior to the Panic of 1907, there was an all-pervading aura of prosperity occasioned by favorable business, good farm crops and prices, corporate mergers, and high earnings. Even the Panic of 1903—essentially a rich man's panic that hardly touched the nation as a whole—failed to stop the upward course of the boom at the turn of the century.

304. The statistics in the foregoing from the decade 1899–1909 or from 1900–1910 are not intended to negative the finding that the returning wave of prosperity began in 1896, and was thus underway at the time of the reorganization of the U.P. in 1898. It has been said that fortune smiled on the Republican party after McKinley's election.

(b) *The U.P.'s Increasing Prosperity*

305. Edward H. Harriman became chairman of the Union Pacific's executive committee in May, 1898, when he was just short of 50 years old, and later chairman of its board, president and chief executive officer. He first came to the U.P. in 1896 from successes with other railroads, and since that time he had been a director and member of the advisory and executive committee and closely involved with Jacob H. Schiff of Kuhn, Loeb & Co. in the reorganization committee and a large participant in the Purchase Money Syndicate.

Harriman had during the reorganization made clear his intention to take control of the road, and he soon came to dominate the Union Pacific, from about 1897 (and possibly earlier) until his death in September of 1909.

His remarkable personal qualities—prodigious memory, capacity to marshal facts, good judgment, courage in large

business decisions—were exercised on behalf of the U.P. to its great profit, until the Panic of 1907.

306. He had a large personal stake in the Union Pacific—stock acquired mainly at low prices beginning in 1898; and by the dynamic character of his operations he brought into the company many millions of new capital. His purchases of interests in other railroads for the U.P. and his improvements of the U.P. were undertaken in a period of almost uninterrupted business improvement and prosperity. Business, as defendant's expert testified, was consistently good from 1897 to 1907.

Harriman brought great profit to the Union Pacific in the time of his administration, until the Panic of 1907, followed by his death not long thereafter.

Some measures of the U.P.'s improvement during Harriman's leadership are that in the period 1900–1906 its gross earnings increased nearly 42 percent and its net earnings increased 69 percent; its income from investments increased from $2.7 million to $10.3 million; and its net income available for dividends increased by $19.2 million or 152 percent.

Dividends on the 4 percent preferred began in 1899, in the first full fiscal year following reorganization, with a 3½ percent dividend (on the par of $100).

Dividends on the common began in 1900 with a payment of 3½ percent (on the par of $100), went to 4 percent in 1901, to 4½ percent in 1905, to 6 percent in 1906 and, a major feat for Harriman, to 10 percent in 1907.

Improvement in the very first years and the foreseeability in January 1898 of improvement brought about by Harriman are the subject of following findings.

307. Correctly judging that the depression had run its course in 1896 or 1897 and would soon be followed by a new wave of prosperity, Harriman's first venture on behalf of the U.P. was a renewal in 1898 of U.P.'s plant. The decision to spend the very large sum involved was the product of a characteristic combination of his prosaic belief in good maintenance, efficiency and fine equipment, his excellent judgment in matters of economic forecasting and his courage in risking large sums on grand plans.

While the road was in good condition in 1887, it had deteriorated during the receivership, and Harriman found it in need of much rehabilitation when he made a daylight inspection trip of the Union Pacific, Oregon Short Line and Oregon Railroad and Navigation and proposed by wire and by letter a $25 million rehabilitation program. So great was his confidence in the outlook for a new wave of prosperity and in his own judgment that he ordered millions of dollars worth of materials and supplies before obtaining approval of the board of directors on his return. The board acquiesced, though some misgivings were expressed, and Harriman's program was ratified. (No finding is made on the dates and details of the events in this paragraph because the sources are contradictory and unreliable.)

Harriman proved to be right in his views that the Union Pacific should prepare for coming prosperity before its rivals by improving its roadway and buying more powerful locomotives and bigger cars. Through expenditures of $45 million in the years 1898–1902, the Union Pacific System placed itself in an impregnable position to handle the rising volume of traffic that followed the acceptance of the gold standard in 1896 and strong foreign demand for the nation's rising wheat crops.

Harriman continued to plow back the rising earnings of the Union Pacific until the road was regarded as one of the finest in the world. There can hardly be any question but that under the excellent management of Harriman the Union Pacific enjoyed a rapid metamorphosis from a rundown railroad to one of superior standards.

308. At the same time that Harriman was demonstrating his soundness in the rehabilitation and operation of the U.P. he was planning great enlargements of the road's sphere of influence such as the acquisition of majority or controlling interests in the Southern Pacific, the Northern Pacific and the Chicago, Burlington and Quincy.

The Southern Pacific owned the Central Pacific, which connected with the Union Pacific at Ogden to make a continuous road to San Francisco, and it also controlled the Pacific Mail Steamship Co. The Northern Pacific controlled the Burlington, a competitor in the Union Pacific's own territory.

309. Harriman's acquisition of the Southern Pacific was disclosed in January, 1901, when it appeared that on behalf of the U.P. Kuhn, Loeb & Company had purchased $75 million par value of Southern Pacific's stock, at under 50 percent of par, of the total of $197.8 million outstanding. Another $15 million par value was purchased by the Union Pacific approximately a year later.

310. To finance the initial purchase and for other corporate purposes, the Union Pacific offered $100 million par value of First Lien Convertible 4s, due May 1, 1911. The approximate market value of the assets conveyed under the indenture was $107,565,800, or only about 7½ percent in excess of the par value of the bonds issued. The $75 million of Southern Pacific stock just acquired and pledged was at that time carried at $50 per share, or a little more than its market value at the time.

The new Union Pacific bonds were convertible at the option of the holder into Union Pacific common stock, at the rate of $100 face amount of bonds for one share of $100 par value stock. On the issue of the bonds, Union Pacific received $100 million in cash, less a commission of $2 million.

311. The investment in the Southern Pacific soon, as will appear, enabled the Union Pacific to make a huge amount of profit which it turned to advantageous reinvestment from the standpoint of current income, which in turn permitted the payment of liberal dividends.

312. In the next year after the Southern Pacific acquisition in 1901, Harriman began a battle with J. P. Morgan and his ally James J. Hill to obtain for the U.P. an entrance into Chicago by gaining control of the Chicago, Burlington & Quincy.

313. Briefly, Great Northern and Northern Pacific had in 1901 obtained control of the Chicago, Burlington & Quincy. When the two Northerns refused to include the Union Pacific as a participant in the acquisition, Harriman attempted to buy into Northern Pacific to obtain control of it and thereby achieve his objective as to the Burlington. Had he succeeded, he would have had an equal interest with Great Northern in the Burlington.

A buying contest ensued; J. P. Morgan and Great Northern also bought heavily into Northern Pacific. Although

Union Pacific acquired a larger interest in the Northern Pacific than the Morgan-Hill group did, the Morgan-Hill group controlled the common and had the right to call the preferred, and the U.P.'s interest was reduced to a minority position through redemption of the preferred stock.

314. The Harriman interests still owned a large block of Northern Pacific common stock and a compromise was effected with the Morgan-Hill group, creating the Northern Securities Company to hold control of both Great Northern and Northern Pacific and thereby hold control of the Burlington. When Northern Securities Company was held by the United States Supreme Court in March 1904 to be a combination in restraint of trade, its holdings of Northern Pacific and Great Northern were distributed pro rata, rather than returned as originally contributed by the parent roads. *See Northern Securities Co.* v. *United States*, 193 U.S. 197 (1904); *Harriman* v. *Northern Securities Co.*, 197 U.S. 244 (1905). The net effect was that the Union Pacific received interests in the two roads which while substantial were inadequate for purposes of control.

Thereafter very large profits were realized from the sale of the securities distributed by the Northern Securities Company.

315. A series of complex financial transactions was the source of the funds to finance the original purchase of Northern Pacific stock, the $15 million additional Southern Pacific stock referred to in finding 347, advances of $20,462,927 to that company, advances of $5,055,311 to Pacific Mail Steamship Company, and acquisition and construction of the San Pedro, Los Angeles and Salt Lake Railway Company at a cost of nearly $20.5 million. The bulk of the money came from the $100 million convertible bond issue sold immediately after the initial commitment to buy $75 million par value of Southern Pacific stock at something under 50 percent of par. Substantial funds apparently also were obtained from banks, and the road's net floating debt on June 30, 1901, was $30,249,459 larger than a year earlier.

Title to the Northern Pacific shares actually was vested in the Oregon Short Line, which obtained funds from Union Pacific by issuing to it purchase money certificates of indebtedness for $61 million. In addition, Oregon Short Line in 1903 issued $36 million 4 percent and participating collateral trust bonds.

316. The net effect of the foregoing and other transactions was that as of June 30, 1904, the Union Pacific had outstanding consolidated net indebtedness of around $289 million, compared with about $149 million on June 30, 1900, before Harriman's plans got underway. The net debt of the U.P. thus rose in this 3-year period, mainly to finance these ventures, by roughly $140 million, or approximately 93 percent.

317. The Southern Pacific did not pay dividends, and it required substantial physical rehabilitation. The impressive improvement in earnings was the chief support for the $4 million of interest called for annually by the bond issue issued to finance the S.P.'s acquisition. In U.P.'s ownership, the S.P. stock produced by June 30, 1901, equity earnings of $4,447,500—$5.93 per share on the 750,000 shares of S.P. purchased in that year, or $4.36 per share on U.P.'s outstanding common. Moreover, the interest requirement diminished as, increasingly, the bonds were converted into common stock pursuant to the option attached to the bonds.

318. Indeed, the rate at which the privilege of conversion was exercised by the holders of the 4 percent bonds issued to finance the Southern Pacific acquisition (finding 348) was an index to the steady improvement in the Union Pacific's position in this period. Only $12.7 million face amount of these bonds had been converted as of June 30, 1904. Another $56.1 million was converted in the fiscal year ended June 30, 1905, and another $32.7 million was converted after the increase of the dividend on the common from a 4 to a 5 percent basis in October 1905 and to a 6 percent basis in April, 1906. As of August, 1906, all except $500,000 face amount of these bonds had been converted.

319. (a) The defendant's expert testified that the impressive improvement in U.P.'s earnings which supported the interest requirements on the bonds issued to finance the Southern Pacific acquisition was not generally foreseen.

(b) It is found that the impressive improvement in earnings, while in its full extent not generally foreseen, was as a trend foreseeable by a reasonably informed investor. The

significance of the acquisition of the Southern Pacific as a source of business and profit for the U.P. was foreseeable; and the reasonably aware investor could appreciate the context—the management's continuing and successful efforts to reconstitute the Union Pacific System, in a setting of increasing national prosperity.

320. (a) The defendant's expert testified that

Harriman's ventures entailed tremendous financial risks and that had he not engaged in them the Union Pacific no doubt would have been a highly prosperous property in its own right, for nothing of a permanent nature was realized from an operating standpoint from Harriman's financial escapades.

(b) It is found that the ventures were risky only in that they were of very large scope; that the ventures cannot be described as "financial escapades"; that they were sound, foreseeably profitable to U.P. and that the profits were soon realized; in short, that the ventures were exceedingly good investments—"eminently successful" and the source of a "fabulous" amount of profit for the U.P., as defendant's expert testified—which enlarged the Union Pacific's system and in a remarkably short time brought it profit from an operating and investment standpoint.

321. (a) Defendant's expert testified that

Harriman had "speculative leanings"; that he was "audacious"; that his ventures were "risky," "daring," "escapades" and "forays."

(b) It is found that these and other depreciations of Harriman are without basis and unwarrantedly seek to minimize the value to the U.P. of his management talents and the reflection in the value of U.P.'s stock of the profits he brought to the U.P.

322. (a) The defendant's expert testified that

Harriman correctly judged the upturn in business conditions in 1897, and yet testified that if business conditions had not been consistently good from 1897 to 1907 some of Harriman's escapades could well have plunged the U.P. into trouble again.

(b) It is found that the conclusion in the foregoing subparagraph (a) is rejected as an improper characterization of

Harriman's sound and successful business steps and as an effort without basis to deprive the valuation of the U.P. stock of the value of Harriman's talents and successes.

323. (a) The defendant's expert testified that

Harriman's successes hardly alter the conviction that he risked the future of the Union Pacific from the standpoint of finances, operations and the public interest; that his ventures heavily involved the Union Pacific's credit and financial integrity, and could have been as disastrous as they were in fact ultimately profitable.

(b) It is found that there is in the record no data, other than the mere size of the ventures and the sums involved, to support the conclusions in the foregoing subparagraph (a). Superbly planned and executed ventures by all but inspired corporate leadership, so soon and so successful as these were, cannot be denigrated with the cliche that any venture can fail.

This is not to say that the value of the corporate stock at the beginning of such ventures is to be measured by the full actual success later realized. The reasonably good prospects for the success of the ventures must, however, go into the scales in the valuation.

324. Harriman's period of management was one of improvement in U.P.'s value generally, and not only in consequence of his acquisitions of interests in Southern Pacific, Northern Pacific and Burlington. The improvement could be seen in the brief year between the effective creation of the new company on January 31, 1898 and the exchange offer of the Oregon Short Line stock on January 26, 1899 (finding 424 et seq.). In that period alone, the U.P. became a considerably stronger road.

The prospects of this improvement were to a degree foreseeable by reasonably informed investors in January 1898, by reason of the knowledge available to and in the financial community, which knew of Harriman's talents and had witnessed since 1896 his increasing degree of leadership of the U.P.

325. (a) The defendant's expert testified that

While the financial condition of the U.P. was good at the time the reorganization became effective in January, 1898 (see finding 295), the current financial position of the

reorganized road as of June 30, 1898, was not robust, for current assets of $7,598,045 exceeded current liabilities of $4,468,416 by only $3,129,629. A year later, the balance sheet showed an excess of current assets over current liabilities of only $1,109,098. Moreover, the liability side did not include a dividend of $1,500,000 declared on the preferred, which was payable in cash on October 2, 1899. A significant change for the better took place in the current financial condition of Union Pacific during November 1899, when the receivers of the old Union Pacific Railway Company made a cash distribution on claims against that company. The plaintiff's proportion amounted to $5,249,090, which, together with the balances in the treasuries of Oregon Short Line and Oregon Railroad and Navigation Company, gave the combined system a cash balance of $11,385,793 on December 1, 1899. By June 30, 1900, the situation was not so favorable again. Cash and cash items had dwindled to $7,957,896 and in addition station agents and conductors held cash of $579,363. Including these items and accounts collectible of $3,027,350, total current assets amounted to $11,564,-610. Current liabilities totalled $7,486,611, leaving what the road called "Balance, Cash Assets" in the amount of $4,077-999. Additionally, the liability side of the balance sheet listed interest and sinking funds accrued but not due in the amount of $449,538 and dividends payable of $3,904,146 on October 1, 1900. On June 30, 1901, Union Pacific was running extremely serious financial risks inasmuch as on a consolidated basis it had a net deficit of $25,779,808 in working capital and also had declared dividends of $4,071,006 payable October 1, 1901. This abrupt decline in its working capital position was due to plaintiff's acquisitions of stock in the Southern Pacific and Northern Pacific, as described above.

(b) The foregoing testimony and conclusion in the foregoing subparagraph (a) are rejected as misleading.

(1) Any implication that the condition or value of the Union Pacific worsened following the reorganization would be incorrect. The reorganization was a good one, the cash position of U.P. was reasonably good and its credit was good, and its general condition kept constantly improving from the moment the reorganization was effected.

(2) The quality of the risks in the acquisitions of the Southern Pacific and Northern Pacific have been discussed above; the risks were not, as the witness implies, serious. The obligations assumed and the effect on cash in consequence of these investments did not create "serious financial risks" but were good business.

(3) The approximate size of the distribution of such a sum as the $5,249,090 distributed to the Union Pacific by the receivers was doubtless foreseeable and known well in advance, on the basis of management's and investors' knowledge of the relationship of the total claims to the amount of assets to become available for satisfaction of the claims. The exact sum may not have been foreseeable and forecast, but that a claim would be paid, and its magnitude, would have been known long in advance.

10. *Approaches by the Government to Valuation of the Reorganization Stock*

(a) *Propects for Reacquisition of the Oregon Lines*

(i) *History of the Oregon Lines*

326. The Oregon Short Line Railroad was organized in February 1897 as the successor to the Oregon Short Line and Utah Northern Railway Company, which had been sold under foreclosure in January that year. The properties—primarily a road from Ogden to the Idaho-Oregon border—were turned over to the new company on March 16 of the same year.

The predecessor, the Oregon Short Line and Utah Northern, had its beginnings in 1881 as the Oregon Short Line Railway Company. The last-named had been created by the Union Pacific to provide it with a connection with the Oregon Railway and Navigation Company, organized in 1879 and still in the blueprint stage but planned to run from the Idaho-Oregon border to the coast.

In 1889, the plaintiff's predecessor, which owned a large majority of the outstanding Utah and Northern Railway bonds and stock, merged the Utah and Northern with the Oregon Short Line, thereby creating the Oregon Short Line and Utah Northern. The latter, on December 31, 1896, owned

$13,006,678 of the outstanding $24,000,000 stock of the Oregon Railroad and Navigation Company, of which $13,000,000 was pledged under its collateral trust 5s 1919 and the remaining $6,678 with the Union Pacific.

Other lines merged into the Oregon Short Line and Utah Northern were the Idaho Central and the Utah Central, the latter itself a consolidation of the Utah Central, the Utah Southern, and the Utah Southern Extension Railroads.

327. As earlier indicated (finding 296) the Oregon Short Line was financed by the issue of $29 million in securities, half in bonds and half in stock, 50 percent of the stock being issued as a bonus to the purchasers of the bonds and the other 50 percent of the stock being issued to the plaintiff's predecessor for no consideration.

328. The cost of construction was $14.5 million, half the $29 million capitalization. Bonds in the amount of $14,931,000 were issued to finance the cost, and were sold at face. (See finding 258.)

Expenditures for new construction to December 31, 1886, amounted to $3,379,405.56 for the Utah and Northern Railway and $890,978.92 for the Utah Southern. Information on other expenditures is not available.

329. At the time of the reorganization of the Oregon Short Line and Utah Northern in 1897, the road had outstanding $36,794,000 mortgage bonds, which, in view of the practice of using the bonds to finance construction and issuing the stock as a bonus, probably represented the true cost of construction of the various lines comprising the property. In addition, the Oregon Short Line and Utah Northern had outstanding $13,000,000 collateral trust 5s 1919 secured by an equal amount of Oregon Railroad and Navigation Company stock. In the reorganization, the Oregon Short Line issued or assumed $34,054,000 fixed interest bonds and $22,026,000 income Series A and Series B bonds, the Series B issue of $14,841,000 being secured by the Oregon Railroad and Navigation Company stock. Pursuant to the plan of reorganization, bonds with a face value of $21,755,000 remained undisturbed and other mortgage bonds with a face value of $14,370,000 received 50 percent in new Oregon Short Line consolidated mortgage 5s 1946, 50 percent in new income Series A bonds, and 100 percent in new common stock.

Holders of the $26,180,200 old common stock received one-half share of new common stock upon payment of an assessment of $12, for which holders received an equivalent par value in the new consolidated 5s. Scaling down of the old common stock by 50 percent had the effect of squeezing $13,090,100 of water out of the old capitalization, but this was in substance offset to the extent of $14,370,000, representing the amount by which new securities given to the aforementioned "other mortgage bonds" exceeded their face value, although there was some consideration in the form of lowered interest and acquiescence in new extended maturity dates.

330. Accordingly, the total cost of road and equipment of $67,508,189 appearing in the Oregon Short Line balance sheet of June 30, 1898, was probably still overstated despite the reorganization, in the light of the water in the capitalization of the original Oregon Short Line and the probable water in properties added to it.

331. The Oregon Railway and Navigation Company was in receivership from October 13, 1893, to August 17, 1896, and was then reorganized under the name of the Oregon Railroad and Navigation Company. The new company issued bonds having a face value of $20.1 million, $11 million par value of preferred stock, and $24 million par value of common stock.

(ii) *The Oregon Lines in 1898*

332. There can hardly be any question that the Oregon Short Line occupied a most strategic position from the standpoint of the Union Pacific. With the Oregon Short Line and the Oregon Railroad and Navigation Company as part of its system, the U.P. had a line to the Pacific Coast; without these two Oregon lines, the U.P. terminated at Ogden and was in a very weak position in interchange traffic, particularly the transcontinental movement. The reacquisition of the Oregon Short Line, lost or deliberately let go in the reorganization (finding 295), as well as other parts of the old Union Pacific system, was therefore essential to protect the position of the U.P.

333. As far back as early 1896, Mr. Mink, then one of the receivers of the Union Pacific, stated that while the U.P.

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reorganization plan did not specifically provide for inclusion of the Oregon Short Line, "There is a strong probability that we shall retain it." At another point, Mr. Mink said, "I think that the loss of the OSL would be almost irretrievable." On October 30, 1897 it was reported that the reorganization committee had "comprehensive plans" for recovering the "old Union Pacific system."

334. (a) The defendant's expert testified that

(1) Of the $27,460,100 par value of common stock issued in 1897 by the reorganized Oregon Short Line, $8,460,000, or 84,600 shares, was acquired by the Union Pacific reorganization committee in December, 1897. This stock was purchased by Kuhn, Loeb & Company, representing the reorganization committee, from the trustees of the collateral trust 6 percent Notes due 1894. From all indications, the assessment on the old Oregon Short Line and Utah Northern stock had been paid, apparently by the trustees of the 6 percent Gold Notes.

(2) In March, 1898 the committee increased its holdings of Oregon Short Line common, and as of March 28, 1898, held a total of 120,093 shares at an average cost of $21.10 per share, including interest and commissions. These shares were transferred to the Mercantile Trust Company under a syndicate agreement which apparently gave the Union Pacific the right to purchase this stock. Within the next several months, additional Oregon Short Line stock was purchased, and, at the end of August, 1898, the Union Pacific and Kuhn, Loeb agreed that the latter would buy for $3 million (or approximately $23.73 per share) the 125,679 shares of Oregon Short Line common then held by the Trust Company plus 750 shares to be acquired by the Union Pacific. A condition of the sale was that Kuhn, Loeb had the right to resell this stock to the Union Pacific prior to December 31, 1899, for its cost of $3 million plus interest of 5 percent.

(b) The foregoing testimony is rejected as materially incorrect and misleading. It is found as follows:

(1) Pursuant to the plan to reacquire the U.P.'s subsidiaries (findings 298, 299) the U.P.'s reorganization committee had bought up foreclosed Oregon Short Line stock and by December 1897 it had acquired 84,600 shares of the 274,601

shares of the reorganized Oregon Short Line from Kuhn, Loeb & Co., who were acting as bankers and financial agent for the committee. The shares remained with Kuhn, Loeb & Co. as security for the purchase price.

(2) The committee was acting on behalf of the new company which would acquire the road, that is, the new U.P., the present plaintiff. An agreement of February 23, 1898, which recites the purchase and makes further purchases, of which more below, disclaims personal liability of the members of the committee. The members promised only that they charged funds at their disposition with the agreement and that they would cause the new U.P. to agree to pay the monies due under the agreement and to assume performance of the agreement.

(3) It appears from the recitals in the agreement that Kuhn, Loeb had as of that date, February 23, 1898, bought additional Oregon Short Line common shares (whose number is not given throughout the agreement) which the committee desired to purchase, and that the committee desired Kuhn, Loeb to purchase for its account still further shares, which together with the 84,600 and the "additional" shares would aggregate 137,301 shares.

(4) The agreement then goes on to provide that Kuhn, Loeb hereby sell to the committee, and the committee purchases, all the said shares of Oregon which have been purchased by Kuhn, Loeb in addition to the 84,600 already belonging to the committee, for a consideration of cost plus $1 per share for each share beyond the 84,600; the same rate was to be paid for the still further shares mentioned above.

(5) As of March 28, 1898, a settlement of accounts under the February 23 agreement among Kuhn, Loeb & Co., the committee and the U.P., showed the total number of shares "purchased under the agreement of February 23, 1898" to be 120,093, for which the committee owed Kuhn, Loeb $2,533,608.25. It does not appear how many of these, beyond the original 84,600, were the "additional shares" sold to the committee by the agreement of February 23, 1898, and how many were bought between February 23 and March 28.

(6) It is therefore apparent that a part of the shares additional to the first block of 84,600 had already been pur-

chased by Kuhn, Loeb prior to February 23, 1898, and thus perhaps even prior to the effective date of the reorganization, January 31, 1898. In view of Kuhn, Loeb's position in the reorganization, any such shares would have been bought with a view to resale to the new U.P. or at least control by the U.P. as part of the plan for reacquisition of the Oregon lines.

(7) The said 120,093 shares of Oregon Short Line, with others to a total of 125,679, were transferred to the Mercantile Trust Company to be held by it as trustee under an indenture called the Auxiliary Lines Syndicate Agreement of March 28, 1898. The function of the Mercantile Trust Company was apparently to act as trustee for the interested parties—those whose money had paid for the stock and the U.P., which had a right to delivery on payment of the stipulated price.

(8) The agreements mentioned in the foregoing were ratified by the U.P. on April 7, 1898.

(9) On August 29, 1898, the U.P. transferred its right to delivery of the said 125,679 shares and sold 750 additional Oregon Short Line shares just acquired—a total of 126,429 shares—to Kuhn, Loeb & Co., who paid $3 million for them, Kuhn, Loeb & Co. to have the right of reselling them to the U.P. at any time between August 30 and December 31, 1899 at cost plus 5 percent interest.

(10) The U.P.'s reason for the transaction does not seem to have been any shortness of funds. There is affirmative indication in the relevant correspondence that the U.P. was not in need of money. The motive for the transaction does not appear from the scanty papers which have been available for the record in this case; it may have been designed with a view to the soon to be announced offer to exchange U.P. stock for Oregon stock (finding 386), and to facilitate the public response to the offer.

(11) Whatever the precise reason for the transaction, however, it is clear that the shares—both those bought before and after January 31, 1898—were safe for U.P.'s interest with Kuhn, Loeb. In view of the long standing plan of the reorganization committee, led by Kuhn, Loeb, to reacquire the U.P.'s subsidiaries for the U.P., the relations between the parties, the U.P.'s overriding need for the Oregon stock and

its apparently adequate financial means at the time, the apparent sale of August 29, 1898 was not a sale of the Oregon shares out of the U.P.'s control, away from the U.P. system or in any way a setback in U.P.'s program to reacquire the Oregon lines, but merely a formal and temporary deferment of open ownership of the stock by the U.P. Control of Oregon had been assured to the U.P. by the earlier buying campaign.

335. (a) The defendant's expert testified that

As of January 31, 1898, the reacquisition by plaintiff of the Oregon lines was probable, but by no means certain. Something might have occurred to prevent reacquisition by the plaintiff. The reorganization committee's 84,600 shares of Oregon Short Line common were only about 30 percent of the 274,601 shares outstanding and not a majority, and there were others seeking control of the Oregon Short Line. As for the Oregon Railroad and Navigation Company, it was controlled not by the Oregon Short Line, but by the Great Northern and the Northern Pacific through ownership of two-thirds of the Navigation Company preferred which was subject to a voting trust agreement. Moreover, little value can be assigned to the prospect of reacquisition. As of January 31, 1898, the Oregon Short Line did not have much earning power. Secondly, the terms of reacquisition were not predictable. It was the reorganization committee, not the plaintiff, which owned the 84,600 shares of Oregon Short Line common. Any benefit to be derived from reacquisition depended to a major extent upon the price the plaintiff would pay for the stocks of the two Oregon lines and the terms of the payment. Finally, reacquisition of the Oregon Short Line without the Oregon Railroad and Navigation Company would have been of little value because the Oregon Short Line ended at the Idaho-Oregon border and did not extend to the west coast.

(b) The foregoing testimony and conclusion are rejected. It is found as follows:

(1) As of January 31, 1898, reacquisition by the new U.P. of the Oregon lines on reasonable terms was substantially certain; further, the Oregon lines had good earning power and were essential to the prosperity of the U.P.

(2) Throughout the receivership it was planned and anticipated by the receivers and the committees and leading

figures in the reorganization that the U.P. would be able to and would acquire the Oregon lines. In carrying out this plan the reorganization committee was acting on behalf of the new U.P.; the committee's ownership was the U.P.'s ownership. Kuhn, Loeb, too, bankers to the reorganization, was involved in the reorganization in the interest of the U.P. Both the committee and Kuhn, Loeb were engaged in a program of acquisition of Short Line stock on behalf of and for the account of U.P. for purposes of eventual control by the U.P. There is nothing of substance in the record to show that the U.P. had rivals in this program or that there were any substantial obstacles to its success. While the committee may not have had an absolute majority of the Short Line stock by January 31, 1898, it definitely had 84,600 shares, ordinarily a number large enough for control. Moreover the "additional" shares which the committee bought from Kuhn, Loeb on February 23, 1898 may already, on January 31, 1898, have been in the hands of Kuhn, Loeb, and in those hands safe for use in the U.P.'s reacquisition of the Oregon. Further, by March 28, 1898 the shares accumulated for the committee—shares of which U.P. was the beneficial owner, albeit subject to payment of their cost—totaled 120,093. These various transactions, even including the accumulation of 120,093 by March 28, 1898, were substantially contemporaneous with the effective date of the reorganization and thus any valuation of U.P.'s stock as of January 31, 1898 should be based on U.P.'s ability to control shares to this number.

(3) The reacquisition was of great value to the U.P. It is incorrect to say that as of January 31, 1898 either of the Oregon lines did not have much earning power. They had been out of reorganization for some time, favorably recapitalized, and launched on successful money-making courses. See findings 391–407. And aside from the Oregon lines' ability to make money on their own mileage, they were, as defendant's expert admitted, most strategic and essential for the U.P., and so aside from their own earning power, they were undoubtedly of great value to U.P.

(4) It is incorrect to say that the terms of reacquisition were not predictable and that benefits would depend on the price fixed by the reorganization committee, the owner of the

stock. The reorganization committee was acting as agent for the U.P. It bought for cost plus $1 per share commission to Kuhn, Loeb, and this would be the price to U.P. The U.P., moreover, as appears from its correspondence with Kuhn, Loeb, was not short of money for the reacquisition program.

Kuhn, Loeb, too, was in the buying program acting for U.P. and could be depended upon to turn over any Oregon shares it bought or held either at a nominal profit or on terms otherwise not onerous to the U.P.

(b) Lastly, it is sheer speculation to suggest that the U.P. might have been successful in its efforts to acquire only the Shore Line and not the Oregon Railroad and Navigation. The Oregon Short Line owned a dominating if not a controlling block of stock in Oregon Navigation and there is nothing in the record to suggest that the U.P. would not be as successful as it soon was (findings 180, 414) in obtaining the Navigation preferred.

336. (a) (1) The defendant's expert testified that his opinion that the reacquisition was uncertain was based on the premise that the reorganization committee did not have control, and that in his valuation he had assumed the probability of reacquisition at something better than 50–50, that is, somewhat better than an even chance.

(2) He further testified that if the probability of reacquisition were raised to 75 percent, he would increase his valuation of the Union Pacific common from $22.50 to close to $30, an increase of 33 percent. Further, that while a 75 percent probability would for purposes of valuation be tantamount to a substantially 100 percent likelihood of reacquisition, if the probability of reacquisition were raised to 90 to 95 percent, he would add $2 more to his per share valuation, bringing it up to $32, an increase of 42.2 percent over his first valuation of $22.50.

(b) It is found that on the basis of the probability of reacquisition having been found to be one of substantial certainty, the probability is comparable to the 90 to 95 percent probability considered by defendant's expert and thus that the opinion of the defendant's expert, on the supposition of the finding made herein of substantial certainty, is that the value per share of the reorganization common is $32 per share, greater than the valuation of $31.76 for the same stock de-

rived from the aggregate valuations by the Commissioner of Internal Revenue of the reorganization and post-reorganization stock (finding 189).

(b) *Stock Market Values*

(i) *The Common*

337. The holder of a stare of old common, who was on payment of the $15 assessment to receive one share of old common plus 15/100ths of one share of new preferred (finding 208) received trust receipts, later replaced by certificates of deposit, for his old common deposited. Trading in the trust receipts began on the New York Stock Exchange on January 23, 1896. The monthly high and low prices and the number of these receipts sold as reported by the Commercial and Financial Chronicle for February 1896 through March 1898 were as shown below. The prices for August 26 through October 19, 1897, were for receipts on which $5 of the assessment had been paid; the prices for October 20 through November 23, 1897, were for receipts on which $10 of the assessment had been paid; and the prices for November 24, 1897, and subsequent dates were for receipts on which the full $15 assessment had been paid.

Month	High	Low	Number of receipts sold
1896:			
February	9	6¾	99,695
March	8⅜	6⅛	36,692
April	10	7⅜	154,947
May	7¼	----	23,954
June	8⅜	6⅛	29,784
July	7½	5¾	26,547
August	6½	4	20,057
September	7½	5	32,385
October	9¼	5⅞	76,122
November	9	12½	131,128
December	11⅝	8	80,390
1897:			
January	10	6¼	162,577
February	7⅝	6½	36,715
March	7⅛	5½	23,181
April	6⅛	4⅛	15,713
May	7⅛	5⅛	44,029
June	8	5⅝	72,860
July	8¼	5⅞	68,418
August	18¼	7¾	319,786
September	24⅞	16¾	611,346
October	27¾	20¼	508,547
November	24¼	18¾	152,366
December	26⅛	23⅞	130,445
1898: [1]			
January	35¼	25¼	530,042
February	36½	26¾	377,436
March	31⅜	23	91,018

[1] Daily figures given in the following finding.

338. For the period beginning January 3 through March 4, 1898, the daily high, low, and average (for the days after February 1) price of the trust receipts sold on the New York Stock Exchange and the number of receipts sold for each week were as follows:

Date in 1898	High	Low	Average	Number of receipts sold during the week
Jan. 3	25¾	25¼	----	----
4	25¾	25½	----	----
5	26¼	25¾	----	----
6	27¾	26⅜	----	----
7	29	28	----	59,389
8	29	28¼	----	----
10	28¾	28¼	----	----
11	29⅞	28¼	----	----
12	31¾	30	----	----
13	31	30	----	----
14	32⅜	31⅛	----	148,349
15	31⅛	30	----	----
17	31⅞	30⅞	----	----
18	31⅞	30⅝	----	----
19	32¼	30¾	----	----
20	32¼	31⅛	----	----
21	31⅞	31¼	----	130,830
22	31½	31¼	----	----
24	31½	30	----	----
25	32	30¾	----	----
26	33¼	32⅛	----	----
27	33¾	33¼	----	----
28	34⅛	33½	----	140,537
29	34⅝	33⅞	----	----
31	35¼	34½	----	----
Feb. 1	36½	35⅛	----	----
2	36½	35½	36	----
3	35⅝	35	35.3	----
4	35⅛	34¼	34.7	176,603
5	35¼	34⅛	34.9	----
7	34¼	33½	33.9	----
8	34⅛	32⅝	33.4	----
9	34¼	33¼	33.8	----
10	34¼	33¼	34	----
11	34½	33¼	34.1	87,671
14	34⅞	33⅝	34.3	----
15	34½	34	34.3	----
16	33⅞	32	32.9	----
17	33½	32⅞	33.2	----
18	33½	32⅞	33.2	71,542
19	32⅛	31⅜	31.8	----
21	31¾	30	30.9	----
23	31⅛	29¼	30.2	----
24	29¼	26¾	28	----
25	30½	28¾	29.6	71,812
26	30½	30¼	30.4	----
28	30½	29¼	30.1	----
Mar. 1	31⅜	30½	30.9	----
2	31¾	30	30.7	----
3	30½	29⅛	30.1	----
4	30¼	28¾	29.5	49,748

339. In order to obtain the cash necessary for payment of the Union Pacific debt to the Government, the reorganization committee sold purchase money certificates to two syndicates. Each certificate had a face value of $1,000 and was exchangeable for $1,000 of new Union Pacific 4 percent bonds and $500 par value of the new Union Pacific preferred stock.

The holder of a certificate was entitled to interest at the rate of 4 percent. For each certificate, the committee received $1,000 in cash.

340. For the period beginning on December 4, 1897, and ending on February 7, 1898, the purchase money certificates were traded on the New York Stock Exchange. The number of certificates sold and the high and low prices stated as a percentage of $1,000 were as follows:

Date	High	Low	Number of receipts sold
Dec. 4, 1897	110½	110½	48
Dec. 6, 1897	111¼	110⅜	66
Dec. 7, 1897	111¼	111	151
Dec. 8, 1897	111¼	111¼	100
Dec. 9, 1897	111¼	111	74
Dec. 10, 1897	110	110	20
Dec. 11, 1897			none
Dec. 13, 1897	110½	110	16
Dec. 14, 1897	111	110¾	35
Dec. 15, 1897	111	110¾	121
Dec. 16, 1897	111⅛	110⅞	108
Dec. 17, 1897	111	110⅞	50
Dec. 18, 1897	111	111	75
Dec. 20, 1897	112	111¼	4
Dec. 21, 1897	111½	111½	5
Dec. 22, 1897	112	111¾	245
Dec. 23, 1897	111¾	111½	95
Dec. 24, 1897	111¾	111⅜	55
Dec. 27, 1897	111½	111¼	25
Dec. 28, 1897	111½	111¼	76
Dec. 29, 1897	112	111¾	79
Dec. 30, 1897	112⅛	111¾	229
Dec. 31, 1897	112¼	112	86
Jan. 3, 1898	112⅜	111⅞	135
Jan. 4, 1898	112¼	112	128
Jan. 5, 1898	112½	112¼	88
Jan. 6, 1898	113¾	112¾	684
Jan. 7, 1898	115⅛	114½	565
Jan. 8, 1898	115⅝	115½	129
Jan. 10, 1898	116⅛	115¾	265
Jan. 11, 1898	117	116½	698
Jan. 12, 1898	118½	117¼	744
Jan. 13, 1898	119⅛	118½	468
Jan. 14, 1898	120⅛	119¾	644
Jan. 15, 1898	120¼	119¼	190
Jan. 17, 1898	119¾	119	419
Jan. 18, 1898	119⅜	119	468
Jan. 19, 1898	120	119½	410
Jan. 20, 1898	120¼	119⅞	227
Jan. 21, 1898	120	119½	167
Jan. 22, 1898	120	119¼	197
Jan. 24, 1898	119⅞	119½	123
Jan. 25, 1898	120	119½	343
Jan. 26, 1898	120¼	120	563
Jan. 27, 1898	120⅛	120¼	572
Jan. 28, 1898	121⅞	120½	755
Jan. 29, 1898	123½	122	338
Jan. 31, 1898	124¼	123¾	303
Feb. 1, 1898	126⅛	125	149
Feb. 2, 1898	126⅜	126	378
Feb. 3, 1898	126⅛	126	240
Feb. 4, 1898	126	126	85
Feb. 5, 1898	126¼	126	40
Feb. 7, 1898	126	126	13

341. Plaintiff's common stock was first traded on the New York Stock Exchange on February 25, 1898. For the period beginning February 25 and ending March 7, 1898, the daily high and low price and the number of shares sold were as follows:

Date in 1898	High	Low	Average	Number of shares sold
February 25	22½	21	21¾	1,600
February 26	22½	22¼	22⅜	400
February 28	22½	22¼	22⅜	100
March 1	22½	22¼	22⅜	400
March 2				none
March 3	22½	22¼	22¾	350
March 4	22	20¾	21⅜	4,600
March 5				none
March 7	18½	17¼	17⅞	1,610

342. The monthly high and low prices (with fractions rounded off to the nearest dollar) of Union Pacific Railroad Company common stock for the years 1898–1901 were as follows:

	High	Low	Average	No. traded
1898:				
January				
February	23	21	22	2,100
March	23	16	19½	43,771
April	21	18	19½	37,997
May	24	20	22	93,395
June	26	23	24½	87,470
July	25	23	24	23,682
August	35	24	29½	293,379
September	34	29	31½	289,954
October	33	32	32½	128,897
November	40	31	35½	255,425
December	44	37	40½	426,226
1899:				
January	50	42	46	560,041
February	50	45	47½	372,480
March	50	44	47	328,886
April	49	45	47	184,226
May	47	41	44	196,830
June	43	38	40½	167,305
July	46	42	44	136,505
August	48	43	45½	291,969
September	48	43	45½	212,516
October	48	42	45	275,742
November	51	47	49	492,596
December	52	40	46	771,009
1900:				
January	49	44	46½	361,860
February	51	47	49	532,711
March	59	48	53½	656,629
April	61	56	58½	821,485
May	57	52	54½	396,910
June	57	48	52½	290,479
July	59	50	54½	585,232
August	61	58	59½	322,672
September	58	54	56	283,169
October	63	57	60	774,542
November	75	61	68	1,007,893
December	81	71	76	839,946
1901:				
January	88	78	83	1,709,690
February	98	85	91½	1,598,305
March	95	86	90½	871,714
April	120	90	105	3,140,980
May	133	76	104½	4,427,275
June	116	105	110½	1,813,860
July	111	90	100½	----------
August	105	93	99	----------
September	102	93	97½	----------
October	103	94	98½	----------
November	109	100	104½	----------
December	104	97	100½	----------

Testimony and other findings are sometimes based on figures not rounded off and may thus vary slightly from the foregoing figures.

343. The annual high and low prices of Union Pacific common stock for the years 1898–1915 were as follows:

	High	Low	Average
1898	44⅝	16⅛	30¼
1899	51½	38⅛	44 13/16
1900	81⅜	44⅜	62⅞
1901	133	76	104½
1902	113¼	93½	103⅜
1903	104⅝	65¾	85 1/16
1904	117	71	94
1905	151¾	113	132⅜
1906	195⅝	138½	166 15/16
1907	183	100	141½
1908	184⅞	110½	147 13/16
1909	219	172½	195¾
1910	204¾	152¼	178½
1911	192⅝	153½	172 15/16
1912	176¾	150¾	163¼
1913	162¾	137¾	150¼
1914	164⅛	112	138 3/16
1915	141½	115¾	128⅝

(ii) *The Preferred*

344. The daily high, low, and average prices for plaintiff's preferred sold on the New York Stock Exchange and the number of shares sold for each week for the period beginning February 2, 1898, and ending March 4, 1898, were as follows:

Date in 1898	High	Low	Average	Number of shares sold during the week
Feb. 2	63⅛	61⅝	62.5	
3	62⅝	61½	62.1	
4	61⅞	60¾	61.3	122,644
5	62⅝	61¾	62.2	
7	62⅜	61	61.7	
8	62	60½	61.3	
9	62	61	61.5	
10	62¼	61½	61.9	
11	62⅛	61	61.6	146,805
14	62⅛	60½	61.3	
15	61⅞	61⅛	61.5	
16	61⅛	59	60.1	
17	60⅝	59¼	59.8	
18	60⅜	59½	59.9	133,253
19	59¼	58½	58.9	
21	57½	55⅛	56.3	
23	57⅜	54½	55.9	
24	53⅞	51	52.4	
25	55	52¼	53.9	167,098
26	54¼	53⅞	54.3	
28	55⅝	53½	54.6	
Mar. 1	57	55⅝	56.3	
2	56¾	55	55.9	
3	55¾	55	55.4	
4	55½	52¾	54.1	123,722

345. The monthly high, low, and average prices of Union Pacific preferred for the first six months of 1898 were as follows:

1898	High	Low	Average	No. traded
January				
February	63	51	57	603,251
March	57	46	51.5	674,941
April	54	49	51.5	521,146
May	60	54	57	603,466
June	63	58	60.5	484,925

346. The yearly high, low and average prices of Union Pacific 4 percent preferred stock for the years 1898–1915 (with fractions rounded off in the first 4 years) were as follows:

Year	High	Low	Average
1898	74	46	60
1899	85	66	75½
1900	85	71	78
1901	100	82	91
1902	95	86⅝	90 13/16
1903	95¼	83½	89⅛
1904	98	86½	92¼
1905	101⅜	95½	98 9/16
1906	99¼	91½	95⅜
1907	96	75	85½
1908	98	79¼	88⅜
1909	118½	94	106¼
1910	103¾	88¼	96
1911	96	89	92½
1912	96½	38¼	92⅜
1913	93½	79¾	86⅜
1914	86	77½	81¾
1915	84⅛	79	81 9/16

347. The average prices paid for the stock in sales in the indicated periods on the New York Stock Exchange, compared with the valuations by defendant's expert, are as follows:

Shares	Valuation dates	Market price range	Time period of price range	Average of market high and low in time period	Valuations by defendant's expert
Reorganization Stock:					
610,000 common	Jan. 31, 1898	$25.875	On Jan. 31, 1898 (fdg. 388)	$21	$22.50
		26-16	Feb. to June, 1898.		
750,000 preferred	Jan. 31, 1898	62.50	On Feb. 2, 1898 (fdg. 382)	54.50	45
		63-46	Feb. to June, 1898.		
Post-Reorganization Stock:					
137,301 common	Jan. 26, 1899 to Feb. 25, 1899	50-42	Jan. to Feb. 1899	46	35
68,650 common	Feb. 26, 1899 to Mar. 4, 1899	50-44	Feb. to Mar. 1899	47	35.25
27,460 common	Mar. 5, 1899 to Mar. 11, 1899	50-44	Mar. 1899	47	35.375
31,642 common	Mar. 12, 1899 to June 30, 1899	50-38	Mar. to June 1899	44	38
1,966 common	July 1, 1899 to Dec. 1, 1899	52-40	June to Dec. 1899	46	43.75
3,688 common	Dec. 2, 1899 to June 30, 1900	61-40	Dec. 1899 to June 1900	50.50	72
2,636 common	July 1, 1900 to June 30, 1901	133-50	July 1900 to June 1901	91.50	112

(iii) *Value Based on Stock Market Prices*

348. The defendant's expert testified that

Consideration has been given, in the valuation of the reorganization stock, to the market prices of Union Pacific securities—to the extent they are available—at the time of reorganization, immediately prior thereto, and shortly thereafter.

349. In 1896, during the reorganization, the common stock of the old U.P. had sold for as low as 3½. In April 1897, less than a year before consummation of the reorganization plan, it sold as low as 4½. From there on, it showed an upward trend as the date drew closer for transferring the assets from the receivers to the new company.

The improved prices of course reflected to a degree the payment of the assessment of $15 per share in three installments of $5 each in September, October and November 1897, although the degree of price rise as reorganization neared was greater than the cash payment.

350. The trust receipts for the predecessor's common stock deposited with the reorganization committee, with all assessments paid, entitled holders to one share of plaintiff's common plus $15 of par value in new $100 par value preferred stock. The trust receipts sold at a high of $24⅛ in November, $26½ in December, and shortly before the new company came into being at midnight, January 31, 1898, they attained a peak of $35¼.

351. The derived market prices of a share of U.P. common on January 31, 1898, based upon that day's high trust receipt price, was $25.875 or $25⅞.

The derivation is obtained as follows: Since a trust receipt equalled 1 share of common plus 15 percent of 1 share of preferred, the value of 15 percent of a share of preferred was $9.375, obtained by multiplying $62.50, the mean price of a share of preferred on February 2, 1898, the first day the shares were traded, by 15 percent. Deducting $9.375 from the $35.25 price of a trust receipt (the high) at midnight January 31, 1898, leaves $25.875 or 25⅞ as the derived price of a share of common stock on January 31, 1898, based on the price of the preferred on February 2, 1898, the first day they were traded. See findings 145, 148–150.

352. When the new shares were first traded on the New York Stock Exchange on February 25, 1898, U.P. common sold at a high of $22.50 and a low of $21. The price fell to $16⅛ in March.

353. At the indicated high of about $25⅞ at about the time of reorganization, the market value of the 610,000 shares of the new U.P. common stock outstanding or to be outstanding was approximately $15.8 million. At the low of $16⅛ in March, the market valuation was slightly over $9.8 million.

354. The range of the new preferred stock on February 2, 1898, the first day it was traded, was 63⅜—61⅝, or an average of 62½. In the following month, it fell back to 45⅞. The high of around 63 was duplicated in June and was decisively surpassed in August when a price of 67½ was attained.

355. (a) The defendant's expert testified that

Considering that the stock was noncumulative and a non-dividend payer, the market's evaluation of the stock was liberal. It was, however, an era of low money rates, and the possibility of initiation of dividends before too long in the light of growing earnings undoubtedly was a potent market influence.

(b) It is found that the foreseeability of growing earnings from a reconstituted U.P. free of Government restrictions, in an era of rising national prosperity, made the market evaluation not a "liberal" index of its value. The dip in market price soon after February was a natural reaction from the opening, and was not a consequence of substantive negative factors.

356. At the high of 63⅜ established on the first day of trading, the market was placing a value of $47.5 million on the 750,000 shares of the new preferred, while at the low of 45⅞ in the following month, the market value of the issue was about $34.4 million. Higher valuation, both at high and low, would follow from the use of the August high of 67½ or the first day low of 61⅝.

357. The 4 percent bonds of the new company opened at 92 on February 1, 1898, which would give the issue a market valuation of $82.8 million.

The high for February was 95⅞ and the low was 92. Three months later, in May, the high and low were 94½ and 91¾, though in the interim they were as high as 95⅞ at which level the market value was nearly $86.3 million.

358. Adding up the mentioned market valuations of the new securities of the U.P. at highs and lows around the time of the reorganization, as noted in findings 353–354, produces the following tabulation:

First Mortgage & Land Grant 4s 1947	$86, 300, 000	$82, 800, 000
4 percent Preferred Stock (noncumulative)	47, 500, 000	34, 400, 000
Common Stock	15, 780, 000	9, 800, 000
Totals	149, 580, 000	127, 000, 000

The foregoing market aggregate values give a range of $127–149.6 million, with a mean of about $138.3 million.

359. (a) The defendant's expert testified

That the market value of U.P.'s securities in later years—even less than a year after the reorganization—turned out to be substantially greater than around the time of the reorganization hardly appears to have much, if any, bearing on the valuation of the railroad when it emerged from the protection of the courts. Changed conditions that could not have been foreseen had a great deal to do with the later prosperity of the Union Pacific, and Mr. Harriman's daring, but successful, speculations based on U.P.'s credit, also contributed heavily to the improved market prices. Those closely connected with the U.P.—ranging from receivers to the members of the first board of directors of the reorganized road (with Mr. Harriman probably the only exception on the latter)—saw no basis for any great optimism, let alone prosperity.

(b) The foregoing testimony and conclusion is not accepted.

(1) It is found that Harriman was not alone in seeing a basis for optimism. His board approved his programs, among them his very early program for large expenditures in physical plant (see finding 307).

(2) The steady rise in market prices reflected enhancements in value not so unforeseeable as defendant's expert testified. The upturn dated from 1896 and Harriman cor-

rectly judged the improving business conditions. The prospects for profits and the enhancements in value soon to come after January 1898 could be appreciated at that time by a reasonably informed investor, although the extent of the coming prosperity could of course not be known. See findings 300 et seq. The inability of those "closely connected" with the U.P. to see the coming prosperity, mentioned by the witness, dates from earlier, depression and receivership times.

360. (a) The defendant's expert testified that

It must be acknowledged that inasmuch as the U.P. had just emerged from receivership and that its new preferred and common stock were nondividend payers, a great element of speculation existed in the stocks. For this reason, it may be concluded that even the low part of the range of $127 million, in the market aggregate valuation set out in finding 396, was not an unduly and severely depressed one.

(b) The foregoing testimony and conclusion is not accepted. It is found that

1. The recency of the reorganization and the fact that the new stock paid no dividends do not establish that the stocks had a great element of speculation, or that the low of the market was a correct value or a "not unduly and severely depressed" value. These factors alone might tend, if prospects were good, as much or more to bring about a substantial undervaluation. In other words, a company just out of reorganization and not paying dividends may be an exceedingly good investment at a market-undervalued price, if it has prospects.

The nondividend paying quality of the stock was in the past. From the very fact of the nature of the reorganization and where the company was left at its end, these were stocks whose past was past. The road had reasonably hopeful prospects for the future; this is the subject of other findings. The stocks did not have a great element of speculation. They were rather superior investments.

2. The "low part of the range of $127,000,000" was in fact "an unduly and severely depressed one," if only because it may well have been based on the recency of reorganization and the lack of present dividends, instead of the great potential for profit that a unique transcontinental system built on the U.P. could become.

The market lows which added together produced the $127 million are the low of 16⅛ for the common and 45⅞ or 46 for the preferred, all in March 1898. These are low points in the second month of trading, in a year in which the monthly averages, except for the falter in March, rose steadily. For preferred the monthly average prices rose in the whole year from 57 to 72, with a dip to 52 only in March and April. The highs rose from 63 to 74, and the lows from 51 to 69. For the common, the average monthly prices rose in the whole year from 22 to 40.5, with a dip to 19.5 in March and April. Highs rose from 23 to 44 and lows from 21 to 37. This first half of 1898 was a time of increases in earnings, of physical renewal of the road, of acquisitions of other railroads.

The drops in market price in about March are properly to be regarded not as reflective of enduring value but rather as hesitations or reactions from the strong opening in January and February. They were preceded and succeeded by prices more reflective of investor's confidence in the fundamental profitability of the road. Because it was to such a degree foreseeable that the upward trend of business profitability would continue and that the U.P. system would be substantially reconstituted and have good and increasing earnings, it is concluded that the low part of the range of $127 million under discussion was in fact an unduly and severely depressed market valuation.

(c) *Net Asset Values*

361. The cost of constructing the Union Pacific, Kansas Pacific, and the Denver Pacific was approximately $82 million, as follows:

	Approximate cost of construction
Union Pacific	$54, 200, 000
Kansas Pacific	22, 651, 000
Denver Pacific	5, 000, 000
Total	81, 851, 000

To the foregoing total of $81,851,000 should be added additions and betterments to the original construction. From 1867 through 1886, capital expenditures on the Union Pacific amounted to $13,765,244.97. In the years 1887–1893, inclu-

sive, expenditures of a similar nature on the Union Pacific (exclusive of branches) amounted to $3,472,602, exclusive of betterments of $1,046,739 charged to operating expense during the period. If the foregoing combined total of $17,237,847 of additions and betterments is added to the above estimated original cost of $81,851,000, the total property investment would be $99,088,847. Capital expenditures during receivership were presumably small. See finding 345.

362. (a) The defendant's expert testified that

What was actually paid by the reorganization committee for the road in terms of (1) new first mortgage bonds issued to old bondholders and (2) cash for the discharge of legitimate longstanding obligations is of course a reflection of the minimum payments essential to acquisition, free of old debts, of the net assets before the reorganization committee.

Total payments of the type covered under (1) and (2), above, amounted to $94,441,535, as follows:

New first mortgage bonds issued to holders of old bonds	$30, 928, 960
Net amount of cash paid to the United States Government	54, 487, 768
Cash paid to nonassenting bondholders	7, 753, 000
Net amount of cash paid for securities of old collateral trust notes	1, 271, 807
Total cash and bonds paid	94, 441, 535

What was given to holders of the old bonds in the form of new preferred stock can be regarded as a bonus to induce them to agree to the plan (see finding 288); likewise, payments made in connection with the reorganization proceedings in cash and securities can be dismissed as not an addition to value, but rather disbursements necessitated by the problems created by earlier inept management. This latter may not have been entirely correct, and there may have been a few millions more in value, since the nature of some of the disbursements made by the reorganization committee is not entirely clear from the records available and there are some discrepancies in these records.

These distributions and disbursements indicate that the net assets of the Union Pacific were worth $95–100 million, plus the value of the land grant property (land contracts and

unsold lands) and various miscellaneous assets. The land grant assets had a value of about $15 million around the time of the reorganization, and the other miscellaneous assets were worth $5–10 million. This would bring the total net asset value up to around $115–125 million.

(b) The foregoing testimony and conclusion are rejected as substantially incomplete and misleading. The list of payments omits items such as the large amounts indirectly utilized in satisfying the Government debt and the stock issued to persuade holders of soon-to-mature bonds to accept an almost 50-year postponement of maturity and a reduction in interest rate (finding 287). The testimony wrongly depreciates and fails to value the indispensable work and contributions to value of the reorganization committee and the Purchase Money Syndicates, not to speak of the reorganization itself.

363. In the testimony given to the United States Pacific Railway Commission in 1887 and the Senate Committee on Pacific Railways in 1896, the valuations placed on the property of the Union Pacific Railway were consistently well below $100 million. The only exception is the valuation of around $116–120 million which can be derived from the testimony in 1896 of Mr. Winslow S. Pierce, counsel for the reorganization committee, regarding the value of the railroad as security for the 4 percent first mortgage bonds to be issued in the reorganization. This valuation is the sum of the following items:

1,477 miles bond-aided, at $50,000 per mile	$73, 850, 000
350 non-aided miles of U.P., plus 270 miles of branches	18, 000, 000
Omaha bridge and terminals at Kansas City and Denver	6–9, 000, 000
Land and land contracts	19, 000, 000
Total	116–119, 850, 000

The foregoing valuations given in 1887 and 1896 (other than that based on Mr. Pierce's views) probably were tinged with a great deal of pessimism, skepticism, and even belligerence toward the U.P. The value worked out on the basis of Mr. Pierce's testimony very likely could be regarded as the optimistic approach, since as counsel for the reorganization

committee he had no reason to denigrate the position of the securities holders by understating the value of the security for the new bonds.

364. The defendant's expert testified that as to what weight should be placed on the price paid by the reorganization committee, the position could be taken that the committee finally paid to the United States Government much more than it considered a reasonable settlement simply to have done with the whole matter and restore the road to the securities holders. The other side of the coin is that the committee may simply have been bluffing—playing a good game of poker, so to speak—in its dealings with the Government, the road's biggest creditor. Some basis for this view certainly appears to lie in the availability of much more money than was actually required to consummate the reorganization. The summary of the committee's receipts and disbursements in the period October 15, 1895, to May 16, 1898, shows that $10,605,000 was returned to the reorganization syndicate and another $9,050,000 in advances also was repaid in cash, presumably representing unneeded funds.

365. (a) The defendant's expert testified that

The value of the net physical assets of the U.P. (including the Kansas Pacific) on January 31, 1898, the time of the reorganization, was $115–120 million. This total includes the lands, land contracts, and miscellaneous assets. If the net debt of $90 million as of January 31, 1898, is deducted from the $115–120 million net asset value, there is a balance of only $25–30 million for the $75 million of preferred stock or only about $33 to $40 per share and nothing for the common.

(b) It is found that net asset value as computed in the foregoing is to be distinguished from value based on prospects for earnings and appreciation and has little materiality to the fair market value of the stock in issue. Net asset value is the value of the lifeless assets, after a depression and a reorganization. Yet the road was the core of a great transcontinental system, which though it had gone through lean years was now free to engage in profitable business.

In sum, the total net asset value as computed by defendant's expert is (a) based at least in part on an incomplete estimate of the "price" paid on reorganization; (b) not material by definition, in that it is based on tangible assets and omits such important considerations as earnings and prospective earnings; (c) belied by stock market values (see finding 247 et seq.) and the judgment of the holders of 610,000 shares of common who paid $15 per share to save their investment; (d) incomplete in omitting any consideration of branches and subsidiaries and the prospects for reacquisition and (e) insofar as it concludes there was "nothing for the common" is contradicted by the final opinion of the defendant's expert himself, who gave a value of $22.50 per share to the common.

(d) *Values Based on Capitalization of Earnings*

366. The operating earnings for the years 1889 through 1897 of that part of the old U.P. system acquired by plaintiff in the reorganization were as follows:

Year	Gross earnings	Operating expenses (including taxes)	Net earnings
1889	$19,775,556	$11,488,816	$8,286,680
1890	20,438,208	13,163,449	7,274,759
1891	19,687,738	11,841,286	7,846,452
1892	20,361,402	11,811,134	8,550,268
1893	17,376,792	11,172,075	6,204,717
1894	14,817,807	10,502,730	4,315,077
1895	14,336,201	9,434,134	4,902,157
1896	14,382,201	9,641,820	4,740,471
1897	16,444,892	10,842,379	5,602,513
Nine year average: 1889–97	17,513,443	11,099,758	6,413,677
Five year average: 1893–97	15,471,615	10,318,628	5,152,987

As already indicated, the foregoing are not system earnings, but only those generated by the 1,822 miles owned by the predecessor U.P. and acquired by plaintiff in the reorganization. For most of the years 1889–1897 the U.P. system included other, branch and subsidiary roads, and thus included a much larger number of miles than 1,822.

367. During the entire nine years which are the subject of the preceding finding, the average track mileage operated was substantially unchanged. It was 1,821.37 in 1889 and a fraction over 1,822 miles in each of the last five years of the period. For the nine year span, total net earnings from operations, after taxes, amounted to $57,723,094, or an average of $6,413,677 per year, while for the five year period total net earnings were $25,764,935, or an average of $5,152,987

per year. If the foregoing averages are capitalized at 5, 6 and 7 percent, they would produce the following schedule of valuations, compared with the corresponding figures for 1897 alone:

Capitalization rate	Average annual earnings of $6,413,677 for 9 yrs. 1889–97	Average annual earnings of $5,152,987 for 5 yrs. 1893–97	Earnings of $5,602,513 for the year 1897
5 percent	$128,273,544	$103,059,744	$112,050,260
6 percent	106,894,620	85,883,120	93,375,216
7 percent	91,623,960	73,614,103	80,035,900

368. (a) The defendant's expert testified that

Since the earnings of a single year can hardly be given great weight, consideration must be given to the record for the period 1889–1897 along with averages for this span of nine years and the most recent five years, which are the subject of the preceding finding.

The use of a 5 percent rate of capitalization is not warranted because of the generally poor status of the U.P. at the time and its far from clear future. As of January 31, 1898, the U.P. had an unsavory history, unfavorable ton-mile rates, poor physical condition, and lots of competition.

The speculative elements of the enterprise may even have warranted acceptance of a 7 percent rate. However, this is too extreme, so the 6 percent figures of about $93 million for 1897, $86 million for the five years 1893–1897, and $107 million for the nine years 1889–1897 are regarded as the most acceptable. A straight average of these three figures—which has a tendency to give weight to recency of trends—produces a figure of $95 million, which is adopted as the earnings valuation of the Union Pacific.

The various earnings valuations referred to in the foregoing paragraph are based on operating earnings alone. They do not give any consideration to the value of the land grants and miscellaneous other assets. If these are taken to be worth (as previously mentioned in finding 362) around $15 million and $5–10 million, respectively, a total of $20–25 million should be added to the earnings valuation of $95 million to produce a January 31, 1898 value of $115 to $120 million predicated on operating earnings and the other stated assets or in the same range as the valuation for total physical assets in finding 365.

(b) It is found that the foregoing valuation, based on capitalization of earnings, and, what is more, past earnings in a depression, in reorganization, with a great debt hanging over the road, is immaterial to the valuation of the stock in issue. Defendant's expert himself seems to be of the same opinion, having based his valuation of the stock on earnings foreseeable, as of 1898, by him.

The valuation by defendant's witness suffers, too, from an exaggerated criticism of the U.P. as having an unsavory history and from a failure to recognize the imminence of the reconstitution of the U.P. system (encompassing, so to speak, an error as to prospects and an error as to retrospective matters, that is, an overabsorption in the past earnings of the U.P. in reorganization, without its branches and subsidiaries).

369. (a) The defendant's expert testified that

At any point in time, it may be possible to predict earnings for the next six months. The farther out in time one goes, the more uncertain the situation becomes. The plaintiff was an agricultural railroad, and its earnings were related to the agricultural situation and, more specifically, crop prices in the United States and Europe. It is very often difficult to determine the crop situation for the current year, and no one can be sure what the crops are going to be in any future year.

To this effect is the following comment in the Chronicle for June 25, 1898:

> The course of the wheat market is being very closely watched in view of its bearing on the prosperity of the farming classes and also on the outlooks for the Western roads in the immediate future. The sudden great change in the price of the cereal has taken many by surprise, and there is a disposition to think that it materially alters prospects in the West.

The close relationship between earnings and the crop situation is also confirmed by the following comment in the Union Pacific report to stockholders for fiscal 1901:

> The operating results obtained during the year, as shown above, clearly indicate that the continued prosperity of the territory served by your lines is most encouraging for the future of your properties. The lack of rain in Kansas and Nebraska affected the corn crop un-

favorably; but, while the tonnage usually derived from that source will doubtless be reduced, it is expected that the excellent wheat crop and the expansion of general business will prevent diminution of the Company's income.

As of January 31, 1898, one could not have foreseen what plaintiff's earnings were going to be for fiscal 1899 or the following years.

(b) It is found that while it is difficult to forecast future earnings precisely, or to forecast earnings any long period ahead, the likelihood of increased and steadily increasing earnings for the U.P. was here to be foreseen from the favorable conditions existing. See findings 300–325.

(e) *Values Based on Price-Earnings Ratios*

370. On the basis of the net operating earnings for each of the years 1894 through 1897 shown in finding 404, assuming other income of $1 million, and deducting fixed charges of $3.6 million and preferred dividend requirements of $3 million, the U.P. had no earnings for its common stock for 1894 through 1896 and only about one-third of a cent per share of common for calendar 1897.

371. In the light of the foregoing finding, it is not feasible to compare Union Pacific common stock with other railroads on January 31, 1898, on the basis of past earnings.

372. The company's first annual report covered only the six months ended June 30, 1898. Not until late in 1899, when the fiscal 1899 report was issued, did the road furnish a record of its operating earnings for fiscal 1898. It did this in providing a comparison with results for fiscal 1899 to show what earnings would have been if the road had owned throughout the two-year period the lines acquired by June 30, 1899. On the assumption that other income and fixed charges in fiscal 1898 would have been the same as in fiscal 1899, earnings on the common stock for fiscal 1898 would have been $2.95 per share after full preferred dividend requirements.

373. (a) The defendant's expert testified that

It is possible, but rather improbable, that on January 31, 1898, one could have foreseen what Union Pacific's earnings would be in the fiscal year ended June 30, 1898.

The generally improved 1898 earnings figures for railroads would not be known for many months after January 31, 1898.

It is probably a fair conclusion that insiders and knowledgeable outsiders had a pretty good idea late in fiscal 1898 that Union Pacific's earnings for the year would be around $2.50 per share or better. But it is hard to believe this could have been anticipated as early as January 31, despite a general improvement in railroad earnings in the six or seven preceding months.

(b) It is found that knowledgeable investers as early as January 31, 1898, had a pretty good idea that U.P.'s earnings for fiscal 1898 would increase and might reach a figure in the neighborhood of $2.50 per share or better and certainly they knew that earnings would go upwards in view of the general improvement in railroad earnings in the half-year preceding, the generally available knowledge of U.P.'s affairs, presumably not kept from the financial and investing community interested in the emergence from reorganization of so important a railroad, and the prosperity of the country.

374. In any event, consideration was given by defendant's expert to price-earnings ratios on January 31, 1898, based on per share earnings in fiscal or calendar 1897 and in fiscal or calendar 1898.

375. A mean market price of $25.50 may be derived for Union Pacific common on January 31, 1898. The derivation is obtained by subtracting from the January 31, 1898 mean market price for the trust receipts of $34.875 (finding 338) the amount of $9.375, the indicated value of the $15 par value of preferred computed as follows: $62.50, the mean price for the preferred on February 2, 1898, the first day traded (finding 344), times .15 or $9.375. When the stock was first quoted on the New York Stock Exchange on Friday, February 25, 1898, the range for the stock was 22½—21 and the volume of trading was 1,600 shares (finding 341). The February 25th range also proved to be the range for the month. The monthly price range for the remaining months of Union Pacific's 1898 fiscal year were as follows: March 23—16; April 21—18; May 24—20; June 26—23. The average of the high and low for the five months was 21⅜.

376. Such price-earnings ratios as in the preceding but one finding were computed for the common stocks of the following ten roads:

Atchison, Topeka & Santa Fe Railway Co. (AT&SF)
Chicago, Burlington & Quincy Railroad Co. (CBQ)
Chicago, Milwaukee & St. Paul Railway Co. (CMSTP)
Chicago & North Western Railway Co. (CNW)
Great Northern Railway Co. (GN)
Illinois Central Railroad Co. (IL)
New York Central & Hudson River Railroad Co. (NYC&HR)
Northern Pacific Railway Co. (NP)
Pennsylvania Railroad Co. (PRR)
Southern Pacific Co. (SP)

The stock of the Great Northern was in fact a preferred, but it was the only stock outstanding and therefore equivalent to a common.

377. Several of these roads had been regular dividend payers for years and therefore their stocks were to be regarded as well-established investments. In this category were the Chicago, Burlington and Quincy, the St. Paul, the North Western, the Great Northern, the Illinois Central, the New York Central, and the Pennsylvania. By contrast, the three other big roads, namely, the Santa Fe, Northern Pacific and Southern Pacific, occupied speculative positions. These railroads differed from each other in the sense that Southern Pacific had some earnings for its common stock throughout the depressed 1890's, the Northern Pacific demonstrated strong recuperative powers after its reorganization in 1896, and the Santa Fe was somewhat slower in recovery after its reorganization in 1895.

378. It is clear that Union Pacific, in emerging from receivership in early 1898 after many lean years, was a good deal more like Northern Pacific and Southern Pacific than those with good records of earnings and dividends. It was therefore only to be expected that the investment grade issues providing regular dividends would command relatively good price-earnings ratios and that the nondividend-paying Union Pacific, Northern Pacific, and Southern Pacific would sell at lower multiples. Moreover, in the later 1890's, interest rates were low; good dividend-paying stocks were in

especial favor and investors were inclined to pay premium price-earnings ratios for roads showing dividend stability.

379. The price-earnings ratios for the common stock of the Union Pacific and the aforementioned ten roads on January 31, 1898, based on per share earnings in fiscal or calendar 1897 and in fiscal or calendar 1898, are as follows:

	Mean price Jan. 31, 1898	Earnings per share on com. fiscal years ended June 30—		P/E ratio based on earnings for—	
		1897	1898	1897	1898
UP	[a] $25.5	Nil	[j] $2.95	----------	8.6
AT&SF	13.375	Nil	Nil	----------	----------
CBQ	100.6875	[e]	8.37	----------	12.0
CMSTP	96.25	[b] $6.10	[b] 9.06	15.8	10.6
CNW[a]	126.4375	[b] 7.00	[b] 9.51	18.1	13.3
GN[b]	139.25	9.83	23.29	14.2	6.0
IL	108.5625	5.33	8.60	20.4	12.6
NYC&HR	118.875	4.35	4.95	27.3	24.0
NP vtc[c]	28.1875	[i]	4.64	----------	6.1
PRR[d]	[f] 59.5	4.19	3.96	14.2	15.0
SP	20	2.38	4.88	8.4	4.1

[a] Fiscal years ended May 31.
[b] All figures related to preferred stock, the only class outstanding.
[c] vtc means voting trust certificates.
[d] Calendar year.
[e] Calculated by deducting 15 percent of mean value of 62½ for U.P. preferred stock on Feb. 2 (range 63⅛–61⅝), amounting to 9.375, from average value of trust receipts, all installments paid, on Jan. 31. 1898 (range 35¼–34½), 34.875.
[f] Price equals one-half of mean on New York Stock Exchange, where quotations were in percentage of par value; the par value of Pennsylvania was $50.
[g] Reported for only six months ended June 30, 1897.
[h] Participating basis.
[i] Reported for only ten months ended June 30, 1897.
[j] Estimated on pro forma basis.

380. Accordingly, on known 1897 earnings, the price-earnings multiples ranged from 8.4 to 27.3 for the roads other than Union Pacific, Sante Fe, Chicago, Burlington and Quincy, and Northern Pacific. Union Pacific and Santa Fe had no earnings and the last two were excluded because their reports did not cover a full twelve months. The higher ratios were for the dividend-paying issues, while the low ratio of 8.4 was for Southern Pacific.

381. On the generally improved 1898 figures most of the multiples came down considerably. Except for New York Central's 24.0, the dividend-paying issues had price-earnings ratios ranging from 6.0 to 15.0. Union Pacific's ratio—based on the $2.95 level mentioned in finding 417, and a price of $25.50—was 8.6, about half way between Chicago, Milwaukee and St. Paul's 10.6 and Great Northern's 6.0. The ratios of Northern Pacific and Southern Pacific—both nondivi-

dend payers, like the Union Pacific—were only 6.1 and 4.1, respectively.

382. (a) Defendant's expert testified that

From these figures, it is evident that U.P. common stock at $25.50 was far from being undervalued on the basis of earnings for 1898.

(b) The foregoing testimony is rejected. The data on price-earnings ratios is not probative on fair market value but shows only that U.P. common was selling at a certain multiple of the earnings figure employed, a ratio less than many but not all of certain other roads.

(f) *Comparison of Union Pacific Preferred With Other Stocks*

383. (a) The defendant's expert testified that

(1) Of the ten other railroads considered, only five had preferred stocks outstanding and that of Great Northern was preferred in name only. Of the four true preferreds in the group, those of the North Western and the St. Paul were investment grade issues, while that of the Santa Fe was a speculation. The preferred stock of Northern Pacific was definitely more comparable with Union Pacific preferred, but even it already possessed a distinctly better standing and had initiated regular dividends shortly before issuance of the Union Pacific preferred. Both Union Pacific and Northern Pacific were similar in being long haul light density railroads operating in the sparsely settled west and both had gone through a cycle of receivership and reorganization in the 1890's. Northern Pacific had been reorganized in the fall of 1896 and issued a report covering only the ten months ended June 30, 1897. In this period, it earned only 65 cents per share on its preferred stock. However, as a spring wheat carrier, it benefitted strongly from the excellent crop harvested in the fall of 1897 and lost no time in inaugurating dividends on the preferred at the 4 percent regular rate provided in the charter. For the fiscal year ended June 30, 1898, Northern Pacific earned $8.95 per share on its preferred. Northern Pacific preferred stock sold in the 30's on the New York Stock Exchange virtually throughout the first six months of calendar 1897, when the earnings' outlook was

drab. In June it started to move out of the 30's as the outlook for the spring wheat crop took form. In January 1898 it sold as high as 69 and on February 2, the date trading began in U.P.'s 4 percent preferred, it sold at a range of 68⅛–67⅜, or a mean of 67¾. At this price it provided a current return of 5.90 percent.

(2) By comparison with Northern Pacific preferred, U.P. preferred suffered. On the latter, earnings amounted to just $4 per share on a pro forma basis for the calendar year 1897, a period that closed only a month before issuance of the U.P. preferred. Since there appeared to be no reason to believe dividends would be initiated in the near future and it was too early to estimate earnings for the six months ended June 30, 1898, the U.P. preferred could hardly be considered as anything but a speculation. As such, it could not be regarded as much more than a common stock with something extra added because of its noncumulative claim to dividends of 4 percent per annum and its voting rights. Looked upon as a nondividend-paying common stock, the preferred would not have been worth more than six to ten times the pro forma earnings of $4 per share for 1897. The conclusion that as a nondividend-payer Union Pacific preferred was not worth more than six to ten times its 1897 pro forma earnings of $4 per share is also supported by the record of Santa Fe's noncumulative 5 percent preferred. In fiscal 1899, when Santa Fe earned close to $4 on its preferred ($3.67 to be exact), the stock reached a peak of 35½. Even in the three months following the close of the fiscal year, it only sold as high as 37½ and was as low as 31⅜. Like Union Pacific preferred, Santa Fe preferred was a nondividend-payer at the time. Applying a multiple of six to ten to the pro forma earnings of $4 per share of plaintiff's preferred for calendar 1897 produces a price of $24 to $40 per share, or a mean of $32. Giving consideration to the possibility of dividend payments of up to $4 per share sometime in the future and the voting rights, a fair market value of $45 per share for plaintiff's preferred is warranted.

(3) As against the valuation of 45 assigned to Union Pacific preferred, the stock actually traded in a range of 63⅜–61⅝, with a mean of 62½, when it made its debut on

the New York Stock Exchange on February 2, 1898. The high of 63⅜ on February 2 proved to be the peak for some time to come and before the short month of February had closed Union Pacific preferred sold as low as 51. In each of the following two months it sold below 50—as low as 45⅞ in March and 48⅞ in April.

(b) The foregoing testimony and conclusions are rejected.

(1) The witness' valuation of the preferred presumably assumes the same degree of probability of the U.P.'s reacquisition of the Oregon lines as underlies his valuation of the common. The preferred is as dependent on prospects of earnings, represented by the prospects of reacquisition of the Oregon, as is the common. The valuation by the witness of the preferred is thus as defective, in respect of the reacquisition of the Oregon, as is his valuation of the common.

(2) The valuation by the witness based on past earnings—for 1897—takes no or too little account of prospectve earnings, the beneficial effect of the reorganization and of increasing prosperity and likely prospective earnings. In short the valuation looks to the past and not the present and foreseeable future.

(3) The valuation is another expression of the witness' belief that earnings cannot be forecast even a few months before the end of a fiscal year; yet it appears from his recount of the affairs of the Northern Pacific that a favorable outlook in June for the harvest of a spring wheat crop was immediately taken by investors as evidence of a prospective rise in railroad earnings.

The professed inability to anticipate earnings to be formally reported in a few months is of special significance here.

The "pro forma" earnings of $4 per share are earnings for calendar year 1897, during reorganization. The same pro forma earnings for a preferred share for the fiscal year ending June 30, 1898 are $6.40. The sharp rise is doubtless in large part explained by the fact that the earnings of $6.40 were computed on the basis of lines owned as of June 30, 1898 and the earnings of $4 were computed on the basis of the U.P. as it stood during calendar year 1897, in receivership, without branches and subsidiaries. (And even the earnings of $6.40 do not consider earnings based on reacquisition of the Oregon lines, which came formally only in 1899.)

Clearly, then, had the witness anticipated even in part the earnings to be reported only 5 months following reorganization, the resulting valuation would be very different than the valuation he gave.

(4) While the preferred stock went to a low of 46 in March 1898, its highs were 63 when trading began in February, 57 in March, and then 54, 60 and 63 in April, May and June, and upwards thereafter. See findings 344–345. The witness seems to have chosen the low point, a point which should be regarded as a reaction, rather than an indication of enduring market value.

The Northern Pacific stock, the witness says, was selling in the 30's when earnings for the period ended June 30, 1897 were "drab"—65 cents per share—and it rose to 69 in January 1898 in anticipation of the June 1898 earnings of $8.95 per share. In the light of these facts, it is difficult to believe that investors were paying $60 for U.P. preferred in 1898, if the witness is correct in his opinion that dividends were not expected.

(5) It is difficult to credit the witness' opinion that dividends were not expected. The testimony is intrinsically contradictory and confusing and the conclusion is without support. First it is laid down that there appeared to be no reason to anticipate dividends "in the near future"; then a value of $32, a mean from the product of a multiple of 6–10 as applied to $4 earnings, is raised to 45, partly as a result of "[g]iving consideration to the possibility of dividends up to $4 per share sometime in the future."

A pattern in which a derogation from value is followed by a contradictory recognition of value appears often in the testimony of the witness, with a possible appearance of objectivity. Another net impression, however, is that of an overstrong negative, first stated, designed to buttress an ungenerous positive statement of value.

11. *Conclusions on the Reorganization Stock*

384. The defendant's expert testified that

Use of the stock values of $22.50 for the common and $45 for the preferred (the witness' conclusions) plus a value of 92 percent for the bonds produces an aggregate value for

plaintiff's assets of $130.3 million ($82.8 million for the bonds, $33.75 million for the preferred, and $13,725,000 for the common). This is within the range of $127–$149.6 million computed by the witness on stock prices (see findings 348–360) but exceeds the range of $115–120 million based on his valuation of the physical assets and his $95 million valuation based on a capitalization of earnings (see findings 359–365).

385. (a) Defendant's expert testified that

(1) The excess value of his valuations over the foregoing valuations is warranted by the fact that the holders of the predecessor's common thought it was worth putting up $15 per share to save their equity and the fact that, since the preferred was noncumulative, there was no danger of piling up accumulations and there was, on the other hand, the possibility of dividend payments on the common at about the same time the preferred might receive them. Other factors warranting these per share values for the reorganization stock were the control value of the preferred and common stocks (both possessed voting rights) and indications that the reorganized road soon would regain control of the Oregon Short Line and the Oregon Railroad and Navigation Company.

(2) The value of $22.50 per share for the common is based not so much on established earning power as on voting rights and potentials for the future. It is consistent with the market action of the stock within the five months following the reorganization, as described in finding 370. Finally, it is confirmed by the price-earnings ratios of the other railway common stocks of similar or better quality, as described in finding 479.

(3) The value of $45 per share for the preferred is warranted by the pro forma earnings of $4 per share for calendar 1897 and the market action of the stock in the first few months after its issuance, as described in finding 483. It is also justified by the comparison with the preferreds of Northern Pacific and Santa Fe, as described in finding 483.

(b) The foregoing testimony is rejected insofar as it purports to support the Government's valuations of the various issues of stock involved.

The testimony refers to a group of factors—control value, "potentials for the future," indications that the U.P. would

"soon" reacquire the Oregon lines and so on—and advances the proposition that these factors warrant the excess of the aggregate valuation by the Government's expert of the stock involved over his several "valuations" based on net assets, past earnings, etc.

Valuations based on such standards as net assets and capitalization of past earnings are in the circumstances of the U.P. not legitimate starting points for a determination of fair market value, and thus it is no support for the conclusion of the Government's expert on fair market value that an "excess" has been added to such "valuations."

The evidence described in the prior findings has revealed the negative, valuation-depressing views of the Government's expert on the potentials for the future, on the probability that the U.P. would soon reacquire the Oregon lines and, indeed, on most or all of the elements bearing on fair market value. These views impeach the credibility of the witness' conclusion on fair market value, whatever the excess over his valuations by other standards such as net assets.

The evidence on the probability of the U.P.'s reacquisition of the Oregon has indicated an increase of his $22.50 valuation of the common to not less than $32, an increase of 42.2 percent. The same percentage increase of his $45 valuation of the preferred brings the value of the preferred up to not less than $64.

12. *Valuation of the Acquisition Stock*

(a) *The Exchange of U.P. Stock for Oregon Stock*

386. In January 1899, stockholders of the Union Pacific ratified a proposal to increase the common stock by 274,601 shares of $100 par value and to offer the new shares to stockholders of the Oregon Short Line on the basis of 1 share of U.P. common for 1 share of Oregon stock plus $3. The U.P. shares so issued to acquire the Oregon common, 273,493 in number, are herein called the post-reorganization stock.

387. There being no evidence to the contrary, Kuhn, Loeb presumably retained the 125,679 shares of Oregon Short Line bought from the U.P. in August 1898 (see finding 334) until

the exchanges began on January 26, 1899 and then exchanged them.

388. Between January 26 and the end of March, most of the Short Line shares were exchanged; by June 30, 265,053 shares had been exchanged and as of that date the U.P. owned about 96½ percent of the Oregon Short Line stock and the Oregon in turn owned a majority of the common stock of the Oregon Railroad and Navigation Company, henceforth called Oregon Navigation.

Thereafter the relatively few remaining shares were exchanged or—as to a very few—acquired by the U.P., which eventually owned all the 273,507 Oregon common shares outstanding.

389. The 273,493 shares of acquisition stock were issued at the following times:

Period:	*Number of shares issued*
January 26, 1899 to February 25, 1899	137,301
February 26, 1899 to March 4, 1899	68,650
March 5, 1899 to March 11, 1899	27,460
March 12, 1899 to June 30, 1899	31,642
July 1, 1899 to December 1, 1899	1,966
December 2, 1899 to June 30, 1900	3,688
July 1, 1900 to June 30, 1901	2,636
July 1, 1901 to June 30, 1902	50
July 1, 1907 to June 30, 1908	100
Total	273,493

(b) *The Dollar Valuations by Defendant's Expert of the U.P. Acquisition Stock*

390. (a) The defendant's expert valued the 137,301 post-reorganization common shares issued in January–February, 1899 at $35 per share. He testified that in the succeeding months of 1899 the value of a common share rose by $1.25 per month. On this basis he valued the 267,019 shares issued between January 26 and December 1, 1899 as follows:

Issue Dates	No. of shares	Value per share
Jan. 26 to Feb. 25	137,301	$35
Feb. 26 to Mar. 4	68,650	35¼
Mar. 5 to Mar. 11	27,460	35⅝
Mar. 12 to June 30	31,642	38
July 1 to Dec. 1	1,966	43¾
Total	267,019	

(b) He valued the 3,688 shares of common issued between December 2, 1899 and June 30, 1900 at $72 per share.

(c) He valued the 2,636 common shares issued between July 1, 1900 and June 30, 1901 at $112 per share.

(d) A recapitulation of these valuations, with aggregate valuations, is as follows:

Issue dates	No. of shares	Valuation per share	Aggregate valuation
Jan. 26, 1899 to Feb. 25, 1899	137,301	$35.00	$4,805,535.00
Feb. 26, 1899 to Mar. 4, 1899	68,650	35.25	2,419,912.50
Mar. 5, 1899 to Mar. 11, 1899	27,460	35.375	971,397.50
Mar. 12, 1899 to June 30, 1899	31,642	38.00	1,202,396.00
July 1, 1899 to Dec. 1, 1899	1,966	43.75	86,012.50
Dec. 2, 1899 to June 30, 1900	3,688	72.00	265,536.00
July 1, 1900 to June 30, 1901	2,636	112.00	295,232.00

(e) The foregoing valuations compared with contemporaneous market averages (finding 347) are as follows:

Issue dates	No. of shares	Valuation by defendant's expert	Average of market high-low prices
Jan. 26, 1899 to Feb. 25, 1899	137,301	$35	46
Feb. 26, 1899 to Mar. 4, 1899	68,650	35¼	47
Mar. 5, 1899 to Mar. 11, 1899	27,460	35⅝	47
Mar. 12, 1899 to June 30, 1899	31,642	38	44
July 1, 1899 to Dec. 1, 1899	1,966	43¾	46
Dec. 2, 1899 to June 30, 1900	3,688	72	50.50
July 1, 1900 to June 30, 1901	2,636	112	91.50

(f) The parties are agreed on a valuation of $175 per share for the 150 shares issued following June 30, 1901. There were 50 such shares issued between July 1, 1901 and June 30, 1902 and 100 such shares issued between July 1, 1907 and June 30, 1908.

(c) *Value of the Oregon Short Line at the Time of the Exchange Offer*

(i) *Value of the Oregon Itself*

391. At the time of the exchange offer, the market price for Oregon Short Line stock was in a good trend upwards ranging from 41 to 48. The stock had quadrupled since it sold at 11 in March 1897, when the line took over the properties of its predecessor. See finding 326. The rise had been a steady one, from 11 to 19 at the end of 1897, on to 40 at the end of 1898 and to 48 in January 1899, without display of serious weakness or violent price fluctuations. The favorable market behavior may have reflected both the rise in Oregon's earn-

ings, to be detailed below, and confidence in its prospects, as well as anticipation of the prospective exchange offer, coupled with confidence in the prospects of the U.P. The U.P.'s intention to reacquire its branches and subsidiaries was well-known, the program of buying Oregon stock on its behalf was very likely known to investors, and some form of exchange was doubtless anticipated substantially in advance.

392. The monthly high and low prices of Oregon Short Line common stock as reported by the Commercial & Financial Chronicle for the years 1897, 1898 and for the first 3 months of 1899 (fractions rounded off to the nearest dollar) were as follows:

Month	Prices of common stock			Number of shares traded
	High	Low	Average	
1897:				
March	13	11	12	
April	11	11	11	
May	12	11	11½	
June	18	12	15	
July	21	18	19½	
August	24	19	21½	
September	23	20	21½	
October	22	18	20	
November	19	18	18½	
December	20	18	19	
1898:				
January	25	19	22	
February	31	25	28	31,224
March	32	27	29½	5,817
April	30	27	28½	800
May	32	30	31	1,428
June	34	29	31½	1,512
July	31	28	29½	808
August	38	31	34½	8,915
September	37	30	33½	3,792
October	30	26	28	1,507
November	37	28	32½	5,854
December	43	37	40	4,756
1899:				
January	48(Jan. 23)	42(Jan. 5)	45	6,471
February	41	41	41	245
March	42	42	42	178

The foregoing are stipulated figures. In apparent contradiction of the figures for February and March 1899, it is also stipulated that during February and March 1899 the stock sold at a high of 44.

393. At the time of the exchange offer, revenues and earnings of the Oregon Short Line were on a sharp trend upwards.

394. (a) The defendant's expert in his testimony implied that the marked uptrend began in fiscal 1899, having been stimulated by the Spanish-American War and the acquisi-

tions of the Philippine Islands and the Hawaiian Islands, which significantly increased traffic to the West Coast.

(b) It is found that the trend upwards dated from the reorganization of the line in 1897 and was as strong in 1898 as in 1899.

395. The trend upwards may be seen from the following:

Oregon Short Line

	Predecessor road—1896	New road and predecessor road—1897	New road 107 days Mar. 16–June 30, 189	Fiscal 1898	Fiscal 1899
Gross earnings	$5,632,726.20	$5,726,247.59	$1,720,797.25	$6,317,058.55	$7,577,108.38
Expenses and taxes	3,114,662.45	3,479,379.36	882,727.05	3,588,460.41	4,751,620.52
Net earnings	2,518,063.75	2,246,868.23	838,070.20	2,728,598.14	2,825,487.86
Income from other sources	Unavailable	Unavailable	2,073.55	198,984.85	437,649.02
Available for fixed charges	Unavailable	Unavailable	840,143.75	2,927,582.99	3,263,136.88
Surplus	Unavailable	Unavailable	Unavailable	158,994.66	346,363.55

396. (a) At the time of the exchange offer, the physical condition of the Oregon was improving.

(b) Defendant's expert testified that nevertheless the physical condition of the Oregon "still left a good deal to be desired."

(c) It is found that the testimony in the foregoing subparagraph (b) is rejected as vague and subjective, unsupported and unconvincing.

397. (a) The defendant's expert testified that

(1) For the 9-year period 1889–1898, adjusted earnings for the Oregon and its predecessor, exclusive of interest on Oregon bonds held by the reorganization committee and dividends received on Oregon Navigation preferred stock, averaged $2,379,076, while for the 5 year period 1893–1898, on a comparable basis, earnings averaged less, at $2,150,987. Neither of these averages was equal to the pro forma fixed and contingent charges of $2,804,710 for the fiscal year ending June 30, 1899. In the fiscal year ended June 30, 1898, operating earnings rose to $2,728,598, to which approximately $60,000 of other income may be added. In the fiscal year ended June 30, 1899—which covered a period ending beyond the acquisition of most of the Oregon stock by the U.P.—earnings amounted to $2,961,197 as adjusted.

(2) If the foregoing figures are capitalized at 5, 6 and 7 percent, the following earnings valuations result:

Oregon Short Line and Predecessor

Capitalization rate	Average annual earnings of $2,379,076 for 9 years 1889–98	Average annual earnings of $2,150,987 for 5 years 1893–98	Earnings of $2,788,598 in fiscal year ended June 30, 1898	Earnings of $2,961,197 in fiscal year ended June 30, 1899
5 percent	$47,581,520	$43,019,740	$55,771,960	$59,223,940
6 percent	39,651,267	35,849,783	46,476,633	49,353,283
7 percent	33,986,800	30,728,386	39,837,114	42,302,814

(3) Comparably to finding 406, regarding capitalization of U.P.'s earnings, a 5 percent rate also seems unwarranted for the Oregon on the basis of the road's financial difficulties, though recognition must be given to the fact that the Oregon Short Line and Utah Northern had very poor earnings only in 1894. Considering the not too unsatisfactory past record of earnings, a 7 percent rate of capitalization perhaps would suggest too speculative an appraisal, an approach not warranted by the facts. Thus a 6 percent rate appears to be a reasonable rate of capitalization. This, according to the above table, produces a range of around $35.8 million to $49.3 million. Again, to give recognition to recency of earnings and admittedly an improving position for the reorganized Oregon, it is appropriate to average the four figures—which produces an earnings valuation of about $42.8 million. Similar treatment of the 5 percent capitalization rate would produce an earnings valuation of $51.4 million. The mean between these two foregoing figures, or $47.1 million—which would produce about a 5½ percent capitalization rate—is justified on the basis of the reasonably stable past record of earnings and the strong uptrend at the time of the Oregon acquisition by U.P. This earnings valuation figure of $47.1 million was the fair market value of the Oregon, exclusive of the value of the Oregon's stockholdings in Oregon Navigation Company.

(b) It is found that the foregoing testimony and conclusions are rejected as conclusions on fair market value, as overemphasizing past earnings and giving too little weight to current earnings, to the good prospects for future earnings, to the significance of the essential position of the Oregon Short Line and Oregon Railroad and Navigation in the

reconstitution of the U.P. system and to the increasing national prosperity.

(ii) *Value of the Oregon's Holdings in Oregon Navigation*

398. The Oregon Short Line held $976,900 par value 4 percent participating preferred (of a total of $11 million) and 162,814 shares of common (of a total of $24 million) of Oregon Navigation Company. Oregon Navigation was the successor to the Oregon Railway and Navigation Company, which had been in receivership from 1893 to August 7, 1896. As noted above, the significance of Oregon Navigation was that it gave the Oregon Short Line an extension to the West Coast from the end of the Oregon Short Line at the Idaho-Oregon border. On the subject of Oregon Navigation and its place in the U.P.-Oregon system, see findings 364–369.

399. In the year ended June 30, 1898, the last fiscal year preceding the U.P.'s exchange offer for Oregon Short Line stock, Oregon Navigation enjoyed a sharp upsurge in earnings to $6.12 per share on the common.

400. Dividends were initiated on the new preferred stock in July 1897, in the first year after reorganization, with a payment of 1 percent, and were followed by similar payments in October 1897 and in January and April 1898, so that the full 4 percent was paid in the fiscal year ended June 30, 1898. The full 4 percent was also paid in the 1899 fiscal year, including 2 percent on July 2, 1898. On the latter date, a 1 percent dividend was paid on the common, the only dividend payment on the common up to the time of the exchange offer.

401. (a) Defendant's expert testified that

At the time of the exchange in the early months of 1899, Oregon Navigation had been operating free of the protection of the court for only about 2½ years and that the stocks of the reorganized company therefore were unseasoned and no dividend record of any significance existed.

(b) It is found that the foregoing testimony is rejected. The implication of fragility from the phrase "free of the protection of the court for only about two and one-half years" is misleading. The road was flourishing. Earnings were on the rise. Profit in fiscal 1898 was outstandingly good, jump-

ing to an impressive $6.12 per share on the common stock; in the following year, in which the exchange took place, earnings declined slightly to $5.88 per share. Dividends had begun and prospects for earnings and continued rise in values were good. The reference to lack of "seasoning" and no "dividend record of any significance" is an unwarranted coloration of the underlying values. Many roads were reorganized following the Panic of 1893. A first dividend after reorganization, so soon after reorganization as in this case, is a good sign and not an occasion for pessimistic notes. Defendant's expert characteristized Northern Pacific's dividend in 1897, after its reorganization in 1896, as one which the declaring road "lost no time" in declaring after it "benefited strongly from the excellent crop harvest in the fall of 1897." Oregon Navigation doubtless benefited from the same harvest and defendant's expert could just as well have said that Oregon Navigation, too, "lost no time" in declaring its first dividends, in 1897.

402. (a) The defendant's expert testified that

(1) In the 9½ years, December 1889–June 1898, earnings of Oregon Navigation available for fixed charges had averaged $1,327,783 annually. On a pro forma basis for the 9½ years (after allowing for approximate depreciation on water equipment and fixed charges in the fiscal year ended June 30, 1898, the first full year of operation following emergence from receivership), net income averaged about $373,000, a sum which would be insufficient to cover the new post-reorganization preferred dividend requirements of $440,000 in full, let alone leave something for the new common stock. In fact, the amount by which net income fell short of what would be preferred dividend requirements ($67,000) was equal to 28 cents per share on the common stock.

(2) In the 5½ year period, January 1, 1893–June 30, 1898, average earnings were slightly poorer than in the aforementioned 9½ year record. As a result, net income in that period fell short of what would be the new preferred dividend requirements by an amount equal to 45 cents per share. Notwithstanding the mentioned inadequacy of earnings in the two periods mentioned, the profit in the last fiscal year in each of them was outstandingly good, jumping to an impressive $6.12 per share on the common stock in the fiscal year ended June 30, 1898. In the following fiscal year, during which the U.P. exchanged its stock for most of the Oregon Short Line stock outstanding, earnings on Oregon Navigation common stock declined slightly to $5.88 per share.

(3) On the basis of the average earnings over the periods of years, preferred and common stocks of the reorganized Oregon Navigation would appear to have had little intrinsic value.

(b) It is found that the foregoing testimony and conclusions are rejected for the same reasons as in the case of the Oregon Short Line, set out in finding 397(b).

403. Reflecting the rising fortunes of Oregon Navigation, the publicly held voting trust certificates (referred to hereafter as "vtc") for its preferred and common stocks experienced sharp advances in the year prior to acquisition of most of the Oregon Short Line stock by the Union Pacific. In 1898, the vtc's for the preferred stock rose from a low of 65½ on March 29 to a high of 78 on November 11. At the end of January, 1899, they sold at 76 and did not vary too much from this level during the rest of the first half of the year, prices generally having been around 72–73. Common stock vtc's rose sharply from a low of 35½ on January 7, 1898, to 61½ on August 22 of the same year. In January, 1899, they fluctuated between a high of 52 and a low of 48½, ending the month on a quotation of 49½–51.

404. The mean between the high and the low for the Oregon Navigation preferred stock vtc's in 1898 was 71¾, while that for the common stock vtc's was 48½. Neither of these differed too materially from the January 1899 month-end quotations of 76 for the preferred vtc's and 49½–51 for the common vtc's. During the rest of the first half of 1899—while most of the Short Line stock was being exchanged for the common stock of the Union Pacific—the vtc's for the preferred showed general firmness due to the payment of full dividends, while the vtc's for the common were in a generally declining trend.

405. Actual sale prices and quotations (the latter indicated by "*") for Oregon Navigation's preferred and common vtc's

at or close to the end of each month in the first half of 1899 were as follows:

	January	February	March	April	May	June
Preferred	76	*70-72	72	69¾	*69-72	72-73¾
Common	*49½-51	*40-46	44	*40-45	34¾	37½-38½

406. (a) The defendant's expert testified that

In the light of the foregoing earnings figures—showing inadequate net income over 9½ year and 5½ year periods, but good profits in the 1898 and 1899 fiscal years—it appears that the fair valuations to use for the preferred and common vtc's as of January 1899 are the average market prices for 1898. On this basis, the 9,769 preferred stock vtc's of the Oregon Navigation Company held by the Oregon Short Line would have a value of $700,926 ($9,769×71¾), while the 162,814 common stock vtc's held would have a value of $7,896,479 ($162,814×48½), a combined total of $8,597,405. If prices for the common stock vtc's in the first half of 1899 were taken into consideration, the market valuation would be lower. However, inasmuch as earnings of the Oregon Navigation held up well in the 1899 fiscal year, there appears to have been no basic reason for the declining trend for the common stock vtc's. Accordingly, the aforementioned combined total of $8,597,405 is the fair market value adopted for the Oregon Short Line's holdings of Oregon Navigation during the Oregon Short Line-Union Pacific exchange. If this valuation is added to the previously adopted fair market value of $47.1 million for Oregon Short Line (exclusive of its holdings in Oregon Navigation), the total would be approximately $55.7 million.

(b) The foregoing testimony and conclusion are rejected for the reasons stated in finding 397(b), and as overly influenced by past earnings in depression and reorganization years; as an unwarranted adoption of stock market prices as the fair market value for large blocks of stock; and as giving too little weight to current and prospective earnings and values, to the significance of the essential position of the Oregon Short Line and Oregon Navigation in the reconstitution of the U.P. system and to increasing national prosperity.

(iii) *Defendant's Conclusion on the Value of the Oregon Short Line and Its Holdings*

407. (a) The defendant's expert testified that

Oregon Short Line stock at the time of the exchange offer from Union Pacific appears to have been overpriced if consideration is given to (1) the probable absence of asset value for Oregon Short Line common stock, (2) the fact that the improved earnings of the Oregon Short Line for the 1899 fiscal year (exclusive of dividends received from Oregon Navigation or equity in its earnings) still amounted to only 57 cents per share before sinking funds, and (3) the value of the Oregon Navigation preferred and common stocks owned by the Oregon Short Line, as calculated above. To have justified a price of around 42 would have required a valuation of around $65.6 million for Oregon Short Line, a level apparently not warranted on the basis of either property or earnings, plus the value of Oregon Navigation stock held. The inference may be drawn that stockholders of the Oregon Short Line received more than adequate treatment.

(b) It is found that the foregoing testimony and conclusions—particularly the conclusion that at the market price of 42 the Oregon Short Line stock "appears to have been overpriced" and that the stockholders of the Oregon Short Line received "more than adequate treatment" in the exchange--are rejected for the reasons stated in findings 397(b) and 406(b) and as overly influenced by past earnings in depression and reorganization years and by asset values, as giving too little weight to current earnings, the prospects for increasing earnings and to the significance of the essential position of the Oregon Short Line and the Oregon Navigation in the reconstitution of the U.P. system and to increasing national prosperity.

(d) *Value of the U.P. at the Time of the Exchange*

408. The influences which were bringing about increases in the earnings of the Oregon lines, described above, were at work, too, on behalf of the U.P., so that at the time of acquisition of the Oregon Short Line, the U.P. in a brief

time had become a considerably stronger road than it had been when it emerged from reorganization. Its earnings were in a strong upward trend, as its report for the fiscal year ended June 30, 1899, subsequently disclosed. Furthermore, considerable progress already had been made on the ambitious program of property and equipment improvement initiated under the leadership of Mr. Harriman. In addition, between November 1, 1898, and February 1, 1899, the U.P. reacquired 924.66 miles of its former branch lines free and clear of mortgages other than those acquired and held by the U.P. itself. These lines, along with another 88 miles bought in June 1899, were purchased for $5,518,248.23 in cash without the issuance of stocks or bonds to reimburse the road's treasury. Acquisition of control of the Oregon Short Line then gave the U.P. possession of 2,543.59 additional miles of line, 1,480.78 operated by the Oregon Short Line and 1,062.81 miles by the Oregon Railroad and Navigation Company. In addition, people close to the U.P. undoubtedly were aware at least as early as 1899 that the road would be entitled to receive a substantial cash distribution at some not too distant date from the receivers of the old Union Pacific Railway Company upon claims against that company, the new company having purchased substantial unsecured claims at large discounts. The distribution was made in November, 1899, with $5,249,089.97 going to the Union Pacific Railroad Company. See finding 325(b)(3).

(e) *The Value of the Several Blocks of Shares Issued in the Exchange*

(i) *The Stock Issued in 1899*

409. Of the 273,493 shares issued in the exchange, 267,019 were issued in 1899, in the period from January 26 through December 2, 1899.

410. Union Pacific common stock itself had without doubt become worth substantially more at the time of the exchange offer than when it was issued in the reorganization of early 1898. Marketwise it was reflecting its improved status in a rising trend on the New York Stock Exchange.

411. The prices for 1898 were as follows:

Month	Prices of common stock		Number of shares traded
	High	Low	
January			
February	23	21	2,100
March	23	16	43,771
April	21	18	37,997
May	24	20	93,395
June	26	23	87,470
July	25	23	23,682
August	35	24	203,379
September	34	29	289,954
October	33	32	128,897
November	40	31	255,425
December	44	37	426,226

412. From a low of 16 in March, the stock advanced vigorously in increasingly heavy trading volume, to 44⅜ in December, and to a peak of 50⅜ in February 1899 before it began a downward drift that culminated in a low of 38⅛ in June before a recovery developed. In the early weeks of the offer to the Oregon Short Line, the range of Union Pacific common was 50⅜–43⅝—which corresponded roughly to the price of the Oregon Short Line, allowing for the $3 payment required for Oregon Short Line stockholders. See finding 341.

413. In its strong rise from March 1898 to February 1899, the U.P. common was reflecting its advancing earnings and basically improved position, as well as the prospective exchange offer for the Short Line and the good earnings uptrends of the Short Line and the Oregon Navigation. Recognition should (defendant's expert testified that "some recognition probably should") also be given to earnings for fiscal 1899. Although it was of course impossible to know in January and February of 1899 the exact amount of earnings for the fiscal year ended June 30, investors would have a pretty good idea of a substantial improvement in earnings.

414. In fiscal 1899 net income amounted to $5,788,209. After allowing for full dividends on the preferred stock (instead of the 3½ percent actually paid), the remaining balance would have been $2,788,209, equal to $3.19 per share on the outstanding common stock, amounting to 875,053 shares of $100 par value. Moreover, since the U.P. owned as of June 30, 1899 about 96½ percent of the Short Line's stock and the Short Line in turn owned a majority of the

common stock of the Oregon Navigation, the U.P. had substantial equity earnings in these properties not included in the abovementioned earnings of $3.19 per share of plaintiff's common. The total of $6.38 of course would have some influence on investors, aside from U.P.'s power to dispose of its affiliates' earnings.

Not until a number of other financial transactions involving the Short Line and Oregon Navigation were completed late in 1899, however, was the Union Pacific actually in a position to determine the disposition of the earnings of these affiliates. Plaintiff issued additional preferred stock in exchange for Navigation preferred, and it issued additional common in exchange for Navigation Company common.

415. After allowing for the abovementioned transactions, consolidated earnings of the U.P., the Short Line, and Oregon Navigation available for plaintiff's common stock on a pro forma basis would have amounted to $5.12 per share in the fiscal year ended June 30, 1899, on the basis of U.P.'s books.

The sum of $1,926,357 for permanent improvements was charged to operating expenses, and to that extent earnings were understated, although generally to the extent no depreciation was charged, the earnings were overstated. This sum of $1,926,357, amounting to $2.20 per share of common stock, if added to the $5.12, would bring total earnings to $7.32.

416. Notwithstanding the acquisition of the Oregon Short Line and the Oregon Navigation in 1899 and the achievement of distinct improvement in earnings in fiscal 1899, the common stock of the U.P. dipped in the middle of 1899, and did not rise substantially throughout calendar 1899. After setting a high of 50⅜ in February, the stock trended downward and made its low for the year at 38⅛ in June, just about as the good fiscal year was drawing to a close. From then on it rose to establish a new high of 51¼ in November.

Monthly price fluctuations in calendar 1899 were as follows:

January	50 -41¼	July	45½-42
February	50⅜-45⅛	August	48 -43¼
March	49½-43⅝	September	48¼-42½
April	49 -44½	October	48¼-41½
May	46⅞-40½	November	51¼-46½
June	43¼-38⅛	December	51½-39⅞

417. (a) The defendant's expert testified that

(1) The basic value of Union Pacific common stock increased substantially between the consummation of the Union Pacific reorganization in early 1898 and the exchange of Oregon Short Line stock in late January and February 1899. The substitution of some solid investment value behind Union Pacific common served to displace some of the potential speculative value that existed at the inception of the new company. The net effect was to add around $10–$15 per share to the fair market value of $22.50 for the stock at the reorganization period. Therefore, at the time of the Oregon Short Line exchange in January and February 1899, Union Pacific common stock had a fair market value of $35 per share.

(2) As it became increasingly apparent that Union Pacific was enjoying significant improvement in its earnings as the close of its fiscal year was drawing near, the conclusion must be drawn that the road's common stock steadily was gaining in fundamental value. By the time all the facts as to Union Pacific's earning power for the fiscal year ended June 30, 1899, were known in mid-December, 1899, the stock had become worth $45–$50 per share. Therefore, over and above the valuation of $35 per share indicated for January–February, 1899, there was an increment in value of about $1.25 per share each month for the rest of the year 1899, resulting in the following values for the Union Pacific common issued in 1899:

Period in 1899	Number of shares	Fair market value per share	Total valuation
Jan. 26 to Feb. 25	137,301	$35	$4,805,535.00
Feb. 26 to Mar. 4	68,650	35¼	2,419,912.50
Mar. 5 to Mar. 11	27,460	35⅜	971,397.50
Mar. 12 to June 30	31,642	38	1,202,396.00
July 1 to Dec. 1	1,966	43¾	86,012.50
Totals	267,019		$9,485,253.50

(b) The foregoing testimony and conclusions are rejected (1) as vague and imprecise ("increased substantially," "some solid investment value," "some of the potential speculative value," "around"); (2) as based on a conclusion (that the value of the stock was $22.50 in January 1898) which has been rejected (finding 385(b))) and because of the reasons for that rejection; (3) as containing an unwarranted implication

of "potential speculative" value at January 31, 1898 (findings 320 et seq.); (4) on the ground that the conclusion that the "net effect" was to add no more than $10–$15 to the fair market value at the earlier date is unreasoned and arbitrary; (5) as giving too little weight to current and prospective earnings and to the reflection of improving values and the value of the acquisition of the Short Line to the U.P. system in the rise in stock market prices from 25⅞ in January 1898 to 50 in January 1899, and (6) as another instance of the witness' reluctance to give sufficient weight to anticipation of formal reports of earnings by even a few months, and thus by implication confirming his failure to give sufficient weight to prospective earnings.

The expert's conclusion that the stock was worth $35–$36 in January–March, 1899 (when most of the stock in question was issued) and $47.50 in December, 1899 (when a relatively minute number of shares were issued) is, therefore, an unreasonable postponement by at least a number of months of the increase in value of the 233,411 shares issued in January–March, 1899 warranted by the improving earnings capable of being appreciated by investors in the second half of the fiscal year 1899.

(ii) *The 3,688 Shares Issued December 2, 1899–June 30, 1900*

418. Between December 2, 1899 and June 30, 1900, the U.P. issued 3,688 additional shares of its common pursuant to the exchange.

419. (a) The defendant's expert testified that

On the basis of Union Pacific's consolidated earnings of $8.76 per share in fiscal 1900 (computed without deduction for the appropriations from income which are the subject of count 8) compared with $5.12 a year earlier, there can hardly be any question that the road's common stock had achieved an entirely new value. Furthermore, it was becoming more apparent that the property was in sound condition and that the earning power was resting on a solid basis. The low operating ratio (operating expenses divided by gross revenues) of 51.59 also attested to the soundness of the operation. The Union Pacific common stock was entitled to sell at about 10–12 times earnings by the time well-informed investors could have become aware of the fiscal 1900 earnings.

This presumably would have been in about July or August 1900. A 10–12 times multiple would have indicated a price of around 88–105 or a mean of around 96½. While this would represent a phenomenal gain over the valuation of 47½ indicated for December 1899 (finding 417(a)(2)), the supporting evidence warrants this finding. The fair market value of the 3,688 shares of Union Pacific issued between December 2, 1899, and June 30, 1900, was $72 per share, the average between the 47½ value as of December 1899 and the 96½ value as of July–August 1900. For the 3,688 shares issued, this produces a value of $265,536.

(b) The foregoing testimony and conclusions are rejected as based on valuations as of earlier dates which have been rejected and for the reasons for such rejection; as vague and subjective, unreasoned and arbitrary; as giving too little weight to current and prospective earnings; and as expressions again of the witness' reluctance to anticipate formal reports of earnings by even a few months.

(iii) *The 2,636 Shares Issued July 1, 1900–June 30, 1901*

420. Between July 1, 1900 and June 30, 1901, that is in the fiscal year 1901, the U.P. issued, pursuant to the exchange, 2,636 additional shares of its common, the last of the shares whose valuation is in issue.

421. (a) The defendant's expert testified that

Determining the fair market value of the 2,636 Union Pacific shares issued in the 1901 fiscal year poses a more complex problem because of the road's speculative ventures at the time, described above in findings 305–325. Earnings of the Union Pacific from its own normal railroad operations continued to move ahead soundly. Reported earnings for fiscal 1901 amounted to $9.09 per share (computed without deduction for the appropriations from income which are the subject of count 8), but would have been higher, had it not been for increased interest charges and an increase in the number of shares of common stock outstanding. These latter two developments were mainly due to the issuance of $100 million first lien convertible 4s, some of which already had been converted by the end of the 1901 fiscal year. Had it not been for these events, earnings would have been $10.31 per share and probably a price-earnings multiple of 12 would have

been justified, giving consideration to the quality of the earnings and their trend. This would have indicated a valuation of around 124 for the stock.

(b) It is found that (1) the first sentence of the foregoing subdivision (a) of this finding is rejected because of the characterization as "speculative" of the ventures which are the subject of findings 305–325; the reasons for the rejection appear in the cited findings; (2) the fifth and sixth sentences, being the last two sentences of the foregoing subdivision (a) of this finding, are rejected for failure to give sufficient consideration to prospects for rising earnings from the U.P.'s investments in Southern Pacific and Northern Pacific; the witness would charge the interest cost of these profitable investments against earnings and thereby lower his valuation, but he does not increase his valuation by any or any sufficient factor taking into account the prospective profits to the U.P. by reason of these profitable investments; and (3) the remaining sentences (the second through fourth sentences) are accepted. and the facts therein are found.

422. Union Pacific's fiscal 1901 total earnings on its common stock, with the addition of equity earnings on its investments in Northern Pacific and Southern Pacific, amounted to $14.81 per share, an improvement of $5.72 over the $9.09 earned by U.P. alone, as follows:

Shares owned by U.P. system, June 30, 1901	Equity earnings per share	Total equity of U.P. in earnings
370,230 NP common stock	$7.77	$2,876,687.00
410,850 NP pfd. stock	4.00	1,643,400.00
750,000 SP common stock	5.93	4,447,500.00
Total		8,967,587.00
Additional fixed charges: $93,957,000×4 percent for 10 months		3,131,900.00
Net addition to earnings		5,835,687.00
Net addition to earnings per share of U.P. common stock (1,020,300 shares)		5.72
Actual U.P. earnings per share		9.09
Total earnings per share (consolidated)		14.81

At a multiple of 12 the earnings of $14.81 would give a value of $177.72 per share. At 11, the value would be $162.91.

423. (a) The defendant's expert testified that

It should be noted that dividends on the Northern Pacific preferred and common stocks held would have produced at $4 per share (the rates paid in fiscal 1901) a total of $3,124,320, or less than the interest requirements on the new

first lien 4s. The equity earnings in Southern Pacific common stock amounted to $4,447,500 (750,000 shares times $5.93), equal to $4.36 per share of Union Pacific common. Since Southern Pacific's earnings were not of as good quality as Union Pacific's or Northern Pacific's, this indicates that the net addition to Union Pacific's per share earnings warrants a lower price-earnings multiple.

(b) The foregoing testimony is rejected, not because of the arithmetical facts stated, but because of unwarranted implied depreciations of value, as follows: (1) the witness puts aside the equity earnings on Northern Pacific, $4,520,087 (see finding 322(a)) in favor of a lower figure, $3,124,320, the dividends paid; (2) the lower figure is then noted to be less than the interest requirements on the new bonds (if $3,131,900 for 10 months, then $3,758,280 for 12 months); (3) then the equity earnings of Southern Pacific are asserted to be not of as good quality as those of Northern Pacific, upon which it is concluded that as the "net addition" to U.P. earnings they "warrant(s) a lower price-earnings multiple" by which is presumably meant a value-earnings multiple. The net addition to earnings was in fact $5,835,687 or $5.72 per share for the 1,020,300 shares outstanding (see finding 418(a)). Even if a lower multiple than that impliedly admitted by the witness to be warranted for the U.P. were utilized, the valuation would be:

U.P.'s own earnings per share $9.09, at a multiple of 12	$109.08
The net addition of $5.72 per share at a multiple of 10	57.20
Total	166.28

424. (a) The defendant's expert testified that

In order to determine the true earning power of Union Pacific common stock in fiscal 1901, the pro forma earnings (including equity earnings in Northern Pacific and Southern Pacific) should be calculated on the assumption of full conversion of the new first lien 4s. This would eliminate the interest requirements on these bonds but increase substantially the number of Union Pacific common shares outstanding from 1,020,300 to 1,959,870. On this basis, earnings on the common (including equity earnings in Northern

Pacific and Southern Pacific) would have been equal to $9.63 per share, including $2.27 per share in Southern Pacific's profits. Thus, on a fully converted basis, earnings on Union Pacific common would have improved only slightly over the actual $9.09 per share and would have deteriorated quality-wise. However, because of the potentially strategic value of the Northern Pacific and Southern Pacific acquisitions, a genuine improvement occurred in the value of Union Pacific common. Therefore, by the end of the 1901 fiscal year, the fair market value of Union Pacific common was around 120–125, or a mean of 122½ (or about 12.7 times the earnings figure of $9.63). Giving double weight to the significant events of the second half of the fiscal year, the fair market value for the 2,636 shares of U.P. common issued during the fiscal year was $112 per share, resulting in an aggregate valuation of $295,232.

(b) The foregoing testimony and conclusion are rejected because

(1) They are based on earlier valuations which have been rejected and contain the same faults as those valuations, and they are unwarrantedly depreciative of current earnings and fail to recognize the current and prospective additions to value of the U.P.'s investments in Northern Pacific and Southern Pacific.

(2) To assume full conversion of the new bonds is unrealistic and serves only to depress earnings per share in the current year. The convertibility feature of the bonds was so designed as to bring about conversion only when profits rose (as in fact occurred, see finding 309). Full conversion came when U.P. was at a high point of profits and had just declared a 10 percent dividend. If full conversion were to be assumed, in fairness it would be appropriate also to assume the profits which would bring about full conversion and be available as per share earnings for an estimate of value.

It would be realistic and fair to reason that the interest cost of the bonds, just issued, is a deduction from the profits realized, and then consider the enduring and increasing profits realized, for purposes of valuation. This the witness does not do. Rather, first he converts these bonanza investments of the U.P. into a slight improvement, with a decline in

quality, in U.P.'s earnings and then, grudgingly recognizing a "potentially" strategic value for U.P. in Northern Pacific and Southern Pacific, he finds a "genuine improvement" over his valuation of $72 for the next earlier period (finding 419 (a)). This improvement he assesses, as a matter of his unexplained judgment, at $40.

(f) *Price-Earnings Ratios and Other Comparisons for 1899–1901*

425. (a) The defendant's expert testified that

(1) The fair market values determined above for Union Pacific common for January 26, 1899, through June 30, 1901, are also warranted by reference to the price-earnings ratios for Union Pacific common and the ten other railroad stocks listed in finding 379. Consideration was given first to the price-earnings ratios as of January 26, 1899, based on earnings for fiscal or calendar 1898 and fiscal or calendar 1899. These were as follows:

	Mean price, Jan. 26, 1899	Earnings per share on common; fiscal years ended		P/E ratio based on earnings for—	
		June 30, 1898	June 30, 1899	1898	1899
UP	$48.3125	[f] $2.95	[i] $3.44	16.4	[j] 14.0
AT & SF	23.5625	[g] 3.80	1.49	----------	----------
CBQ	138.75	8.37	7.74	16.6	17.9
CMST	129.1875	[h] 9.06	[h] 11.51	14.3	11.2
CNW[a]	151.375	[h] 9.51	[h] 11.97	15.9	12.6
GN[b]	167.125	23.29	8.34	7.2	20.0
IL	120.625	8.60	8.49	14.0	14.2
NYC & HR	138.5625	4.95	5.91	28.0	23.4
NP vtc[c]	50.625	4.64	6.01	10.9	8.4
PRR[d]	[e] 68.625	3.96	4.06	17.3	16.9
SP	38.5	4.88	4.55	7.9	8.5

[a] Fiscal years ended May 31.
[b] All figures relate to preferred stock, the only class outstanding.
[c] vtc means voting trust certificates.
[d] Calendar year.
[e] Price equals one-half of mean on New York Stock Exchange, where quotations were in percentage of par value; the par value of Pennsylvania was $50.
[f] Estimated on pro forma basis.
[g] Deficit.
[h] Participating basis.
[i] Pro forma, assuming all properties owned June 30, 1899, had been owned throughout the fiscal year. Actual earnings were $3.19 per share. Following certain financial transactions in the second half of 1899, it was reported in mid-December 1899 that combined earnings of U.P., OSL and ORR & N would have been equal to $5.12 per share on the common stock.
[j] On basis of $5.12 earnings mentioned in note (i) above, the P/E ratio would have been 9.4.

Due to the fact that the prices of the stock uniformly were higher on January 26, 1899, than on January 31, 1898, the price-earnings ratios based on fiscal or calendar 1898 earnings were higher too. Except for New York Central's very

high 28.0 (attributable in part to the fact that reported earnings of that System were understated because they were not reported on a consolidated basis), the price-earnings ratios of the dividend-paying railroads—whose ranks were joined by Northern Pacific—ranged from 17.3 to 7.2. The multiple for Southern Pacific was 7.9, while that of Union Pacific (based on a market price of 48.3125 and earnings of $2.95) was 16.4, a figure not much below the Pennsylvania's 17.3 and Chicago, Burlington and Quincy's 16.6, and above the ratios of all the other dividend-paying railroads, save for the New York Central. Utilization of fiscal 1898 earnings and the above-determined fair market value of $35 for Union Pacific common as of January 26, 1899, results in a multiple of 11.9, which is still in excess of the multiples for Great Northern, Northern Pacific, and Southern Pacific.

(2) On the fiscal or calendar year 1899 earnings, the ratios of the dividend-paying rails on January 26, 1899, ranged from 23.4 to 8.4, while the nondividend-paying Southern Pacific had a multiple of 8.5. Union Pacific's ratios of 14.0 based on the market price of $48 and 10.2 based on the fair market value of $35 exceeded the multiples of 8.5 for Southern Pacific and 8.4 for Northern Pacific, and the former but not the latter also exceeded the multiples of 11.2 for the St. Paul and 12.6 for the North Western.

(b) The foregoing testimony and conclusion—that the price-earnings ratios cited "warrant" or support the conclusions of the witness on the fair market value of U.P. common issued from January 26, 1899 through June 20, 1901—are rejected for the following reasons:

(1) The testimony has no relation to and gives no support to the witness' conclusion—basic to his valuations for January 26, 1899–June 30, 1901—that U.P. common issued in January 1899 was worth $35 per share.

(2) For, also, the reasons stated in finding 382.

(3) The U.P. earnings used to compute the witness' ratios are $3.19 or $3.44 per share, not $5.12 as would be more correct, or $7.32, also tenably correct (see finding 415).

(4) The witness at some points compares a ratio which is the product of a ratio of (his) *value* of U.P. share to earnings with a ratio which is the *price* of other railroads to earnings, a comparison which conveys nothing.

426. For the two periods during which relatively small amounts of Union Pacific common stock were issued in exchange for Oregon Short Line stock—namely, December 2, 1899–June 30, 1900, and July 1, 1900–June 30, 1901—the fair market values testified to by defendant's expert herein, $72 and $112, respectively, are considerably above market price at the time. See finding 342. The period was one of undervaluation for railroad stocks generally. For the most part, earnings were strong in fiscal and calendar 1900. In the following year, results were even more spotty, with some roads showing moderate declines while others realized further gains. In the two-year period the common stocks of many roads sold at relatively low price-earnings ratios, several in fact at less than ten times earnings.

427. (a) The defendant's expert testified that

The average monthly price of Union Pacific common (51.34) in the seven-month period December 1899–June 1900 was only 5.9 times the earnings of $8.76 realized in fiscal 1900. This ratio was no better than that for Atchison, Topeka and Santa Fe common, which was just emerging from a string of deficits. Average monthly prices of the common stocks of the Milwaukee, the North Western, the Northern Pacific, and the Southern Pacific were about ten (or less) times the earnings for fiscal 1900. Thus, of the eleven roads considered, six were in this classification. Even Pennsylvania (on a calendar year basis) and Illinois Central, two of the strongest roads of the era, sold at less than 12 times earnings. It is concluded that rail stocks at the time were unreasonably low and the value of $72 determined for Union Pacific common for the period covered represents fair market value more accurately than did the actual market price. The value of $72 is 8.2 times the earnings of $8.76 for fiscal 1900, a multiple in excess of the 6.8 for Northern Pacific and 5.9 for Santa Fe and not much below the multiples of 9.4 for Southern Pacific and 9.7 for the North Western.

(b) The foregoing testimony and conclusion are rejected

(1) as vague and inconclusive.

(2) because the testimony that $72 represents fair market value "more accurately" than the market price of $51.34, in view of the Government's position and the witness' testimony, is no support for a valuation of $72. Such testimony

is consistent with the proposition that $100 or $200 may represent market value still "more accurately."

(3) because the testimony concerning price-earnings ratios, presumably factual enough, has no relation to and offers no support for the witness' conclusion of a $72 fair market value for the stock issued between December 1899 and June 1900; see the reasons for the rejection of comparative price-earnings data stated in finding 382.

(4) finally, the witness in the last sentence of subdivision (a) of this finding again compares (his) *value* (of U.P.)-earnings ratios with (other railroads') *price*-earnings ratios.

428. For the last period, fiscal 1901, the price-earnings ratios for the eleven roads considered show that, although average monthly prices in fiscal 1901 were a good deal higher than in the preceding seven months, general undervaluation still persisted. In terms of earnings for fiscal or calendar 1900, price-earnings ratios had improved, but, for many roads, they were still low with respect to profits for fiscal or calendar 1901, particularly in the light of the general prosperity of the period. In fact, four of the six roads with price-earnings ratios of about ten or under, based on fiscal or calendar 1900 earnings, fell in the same category on 1901 earnings. Similarly, Pennsylvania and Illinois Central continued to sell at modest ratios, considering their stature. U.P.'s average monthly price of 79.83 for the 12 months ended June 30, 1901, was a conservative 8.8 times earnings of $9.09 per share for the same period. Moreover, it was only 5.4 times earnings of $14.81, including equity in the earnings of Northern Pacific and Southern Pacific. The price-earnings ratio would have been 8.3 if allowance is made for conversion into common stock of the outstanding first lien convertible 4s, resulting in earnings of $9.63.

Regardless of the approach taken, the average monthly price of U.P. common in the 12 months ended June 30, 1901, was low at 79.83. Recognition of this did occur as the fiscal year progressed, for the average price in June 1901 was 110.38, compared with 54.19 in July 1900, and the trend was almost continuously upward. In May 1901, just before the brief "Panic of 1901" broke loose, the stock attained a

peak of 133. It had crossed 100 for the first time in April 1901, reaching a high of 120 that month.

429. (a) The defendant's expert testified that

The correctness of the fair market value of $112 determined for U.P. common for fiscal 1901 is also confirmed by the fact that, based on the earnings figure of $9.63, it reflects a multiple of 11.6 which was significantly exceeded by the multiples for only three of the ten other roads studied: the Burlington, Great Northern, and the New York Central. The multiple of 12 was about the same as the multiples of 13.3 for the St. Paul, 12.1 for the Illinois Central, and 12.9 for the Pennsylvania.

(b) The foregoing testimony and conclusion are rejected for the reasons stated for the rejection of the testimony and conclusion recounted in findings 370–382, 382(b).

13. *Court's Conclusions on Value*

430. The court finds the New York stock exchange prices for the U.P. stock provide the best evidence of value in this case.

431. The average between high and low for the U.P. preferred on February 2, 1898 (*see* finding 236, the valuation date adopted by the court) was $62.50 (*see* finding 344).

432. The value of the U.P. preferred issued in the reorganization was, therefore, $62.50 x 750,000 shares or $46,875,000.

433. The derived price for the U.P. reorganization common on February 2, 1898 is $26.625. This is derived from the average price of trust receipts on February 2, 1898 (*see* finding 338) of $36. Since one trust receipt was exchangeable for one new share of U.P. common and $^{15}/_{100}$ of a share of new preferred ($^{15}/_{100}$ of $62.50 is $9.375), by subtracting the value of the preferred increment ($9.375) from the trust receipt value ($36.), we derive the price for U.P. reorganization common on February 2, 1898 of $26.625.

434. The value of the 610,000 shares of U.P. common issued in the reorganization was, therefore, 610,000 x 26.625 or $16,241,250.

435. We find that the following time periods, and average market prices for such time periods represent the most accu-

rate values for the U.P. acquisition common. (*See* finding 347.)

From	*To*	*Number of shares*	*Average*	*Total Value*
1-26-99	2-25-99	137, 301	$46. 00	$6, 315, 846
2-26-99	3- 4-99	68, 650	47. 00	3, 226, 660
3- 5-99	3-11-99	27, 460	47. 00	1, 290, 620
3-12-99	6-30-99	31, 642	44. 00	1, 392, 248
7-11-99	12- 1-99	1, 966	46. 00	90, 436
12- 2-99	6-30-00	3, 688	50. 50	186, 244
7- 1-00	6-30-01	2, 636	91. 50	241, 194
7- 1-01	6-30-02	50	175. 00	8, 750
7- 1-07	6-30-08	100	175. 00	17, 500
		273, 493	----------	$12, 769, 188

436. We, therefore, find a value for the acquisition common of $12,769,188.

437. The total value for the U.P. stock issued in the reorganization ($16,241,250 for the common; $46,875,000 for the preferred) and the acquisition ($12,769,188 for the common) of $75,885,438.

CONCLUSION OF LAW

Upon the foregoing findings of fact and opinion, which are adopted by the court and made a part of the judgment herein, the court concludes as a matter of law that plaintiff is entitled to recover on its claims in Parts I, V and some sections of Part X; that plaintiff may not recover on its claims in Parts II, IV, VI and VII; and that defendant has the right to recover on its additional defenses in Parts VIII, IX and XI. The amount of the recoveries will be determined pursuant to Rule 131(c). Further, the court hereby remands Part III to the trial division for further proceedings consistent with this opinion.

Pages 245 through 252

Intentionally Omitted